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Ms. Cynthia Brown
Chief, Section of Administration
Office of Proceedings
Surface Transportation Board
395 E Street, S.W.
Washington, DC 20423-0111

Re: STB Finance Docket No. 35506, *Western Coal Traffic League – Petition for a Declaratory Order*

Dear Ms. Brown:

Enclosed for filing in the above-referenced proceeding, please find an original and ten (10) copies of the Joint Rebuttal Evidence and Argument of the Western Coal Traffic League, American Public Power Association, Edison Electric Institute, National Association of Regulatory Utility Commissioners, National Rural Electric Cooperative Association, Western Fuels Association, Inc., and Basin Electric Power Cooperative, Inc. This filing includes three copies of a CD containing the text of the Rebuttal Evidence and Argument, as well as three copies of a CD, marked **Highly Confidential**, containing the electronic workpapers in support of the Rebuttal Verified Statement of Messrs. Crowley and Fapp.

Please date stamp the extra copy of this cover letter and the enclosed duplicate filing and return it to our messenger. Thank you for your attention to this matter.

Respectfully submitted,

John H. LeSeur
An Attorney for the Listed Parties

Enclosures

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BEFORE THE
SURFACE TRANSPORTATION BOARD

WESTERN COAL TRAFFIC LEAGUE – PETITION FOR DECLARATORY ORDER	)))))	Finance Docket No. 35506

231531

JOINT REBUTTAL EVIDENCE AND ARGUMENT OF THE
WESTERN COAL TRAFFIC LEAGUE
AMERICAN PUBLIC POWER ASSOCIATION
EDISON ELECTRIC INSTITUTE
NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS
NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
WESTERN FUELS ASSOCIATION, INC.
AND
BASIN ELECTRIC POWER COOPERATIVE, INC.

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Dated: December 20, 2011

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BEFORE THE
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The Western Coal Traffic League, American Public Power Association, Edison Electric Institute, National Association of Regulatory Utility Commissioners ("NARUC"), National Rural Electric Cooperative Association, Western Fuels Association, Inc. ("WFA"), and Basin Electric Power Cooperative, Inc. ("Basin Electric") (collectively "Coal Shippers/NARUC") present their Joint Rebuttal Evidence and Argument.

PREFACE AND SUMMARY

As Coal Shippers/NARUC emphasized in their Joint Opening Evidence and Argument ("Coal Shippers/NARUC Op." or "Opening Evidence"), and in their Joint Reply Evidence and Argument ("Coal Shippers/NARUC Reply" or "Reply Evidence"), "[t]his case raises a fundamental regulatory question: whether shippers that are captive to BNSF Railway Company ("BNSF") should pay higher rail rates simply because BNSF's ownership has changed hands." Coal Shippers/NARUC Op. at 1; Coal Shippers/NARUC Reply at 1.

The answer to this question is self-evident: captive BNSF shippers should not pay higher rates simply because Berkshire Hathaway, Inc. ("Berkshire") paid a $8.1 billion premium when it acquired BNSF in 2010. For this reason, all shipper parties to this proceeding join in asking the Surface Transportation Board ("STB" or "Board") to remove the premium from the BNSF Uniform Railroad Costing System ("URCS") and revenue adequacy net investment bases,[1] as does NARUC,[2] the United States Department of Agriculture ("USDA"),[3] and all members of the United States Congress who have addressed the issue in letters submitted to the Board.[4]

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[1] *See* Opening Comments of Alliance for Rail Competition, Montana Wheat & Barley Committee, Colorado Wheat Administrative Committee, Idaho Barley Commission, Idaho Wheat Commission, Montana Farmers Union, Nebraska Wheat Board, Oklahoma Wheat Commission, South Dakota Wheat Commission, Texas Wheat Producer Board, Washington Grain Commission, and National Association of Wheat Growers (filed Oct. 28, 2011) ("ARC, *et al.*"); Opening Evidence and Argument of National Corn Growers Association (filed Oct. 28, 2011); Opening Argument of The National Industrial Transportation League (filed Oct. 28, 2011); Opening Evidence and Argument of Consumers United for Rail Equity ("CURE") (filed Oct. 28, 2011); Reply Comments of ARC *et al.* (filed Nov. 28, 2011); Reply Argument of CURE (filed Nov. 28, 2011).

[2] *See* Coal Shippers/NARUC Op., V.S. Charles D. Gray.

[3] *See* USDA Opening Comments (filed Oct. 27, 2011).

[4] *See* Coal Shippers/NARUC Op. at 19-21.

Nevertheless, BNSF opposes removal of the $8.1 billion premium from its URCS and revenue adequacy net investment bases.[5] BNSF acknowledges – as it must – that, unless the Board orders otherwise, the premium will jack-up the variable costs the Board uses to set rates, but nonetheless claims that shippers' rates will not increase and, even if they do, BNSF asserts that is okay, because the premium-bloated costs are "more accurate."[6]

BNSF also concedes that no other public utility regulator would allow inclusion of an acquisition premium on the facts presented here: a premium-generated increase in its net investment base, with no offsetting benefits to utility consumers. BNSF Reply at 21-22. However, BNSF sloughs this off, contending that it is acceptable for captive rail customers to pay premium-generated rate increases because basic concepts of fairness to utility customers do not apply when the public utility is a railroad, and the customer is captive to that railroad. *Id.* at 23-24.

Finally, the Board has approved numerous rail mergers, and acquisitions, over the years on grounds that the mergers would reduce rates and improve service. BNSF argues that the Board's approval of acquisition premiums in those cases governs in the instant case, where inclusion of the premium will increase BNSF's rates and have no impact on BNSF's service. *Id.* at 4-11.

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[5] The Association of American Railroads has also filed a short statement on opening (filed Oct. 28, 2011) and a short statement on reply (filed Nov. 28, 2011) in support of BNSF's position.

[6] See BNSF Reply Evidence and Argument (filed Nov. 28, 2011) ("BNSF Reply"), Joint Verified Statement ("V.S.") of A. Lawrence Kolbe and Kevin Neels ("Kolbe/Neels") at 20.

Coal Shippers/NARUC's Rebuttal submission refutes BNSF's make-weight contentions. As shown in Coal Shippers/NARUC's Opening and Reply Evidence, and confirmed again here:

> - The Board's inclusion of the premium in BNSF's URCS will have significant adverse impacts for captive shippers that litigate STB maximum rate cases against BNSF or rely on STB maximum rate standards in their rate negotiations with BNSF.
>
> - Both acquisition costs and predecessor costs are "accurate." They simply measure different sets of costs, so the choice of which costs to use is not driven by "accuracy" considerations, but instead must be based on regulatory policy considerations.
>
> - The same reasons why public utility regulators exclude premiums in calculating utility rates apply with equal force in the instant case – it is fundamentally unfair for captive customers to pay premiums from which they derive no benefit.
>
> - Board precedent supports exclusion of the premium from BNSF's URCS because the Board has never permitted an acquisition or merger that results in increased captive customer prices, which is exactly what will happen in this case unless the Board removes the premium from BNSF's URCS.

In their Rebuttal, Coal Shippers/NARUC present the argument of Counsel in support of their requests that the Board remove the acquisition premium from BNSF's URCS and revenue adequacy net investment bases, along with expert verified statements from Dr. John W. Wilson, Dr. Robert E. Verrecchia, and a joint verified statement from Thomas D. Crowley and Daniel L. Fapp. Each of these experts submitted verified statements as part of Coal Shippers/NARUC's Opening Evidence.

ARGUMENT

I.

CAPTIVE SHIPPERS' RATES WILL INCREASE SIGNIFICANTLY IF THE $8.1 BILLION BERKSHIRE ACQUISTION PREMIUM IS INCLUDED IN BNSF'S URCS

BNSF maintains that captive shippers' rates will not increase if the Board includes the $8.1 billion premium in BNSF's URCS net investment base. BNSF Reply at 11-21. According to BNSF, few shippers have the ability to bring maximum rate cases before the STB and for those shippers that do bring cases in the future, inclusion of the premium in its URCS will not result in any "material[]" rate increases. *Id.* at 18. BNSF also maintains that inclusion of the premium in its URCS will not impact commercial negotiations in any way. *Id.* at 17-19. These assertions are demonstrably false.

A. Hundreds of Thousands of Shipments Involving Billions of Dollars in Freight Revenues Are Presumed Eligible for Maximum Rate Relief from the STB

The STB has jurisdiction over market dominant rail traffic moving at revenue-to-variable cost percentages of 180% or higher. 49 U.S.C. §§ 10701(d)(1), 10707(c). In measuring the scope of this jurisdiction, the Board generally "presume[s]" that shippers whose regulated traffic moves at revenue-to-variable cost ("R/VC") ratios above 180% are "eligible" to bring rate cases before the Board. *See Simplified Standards for Rail Rate Cases*, STB Ex Parte No. 646 (Sub-No. 1) (STB served July 28, 2006) at 37.

In a study using 2004 data, the Board found that a total of approximately $8 billion in regulated freight revenue was presumed eligible for STB maximum rate regulation because the underlying traffic had R/VC ratios greater than 180%. *Id.* BNSF's { } that BNSF transported { } carloads of regulated traffic in 2010 that is presumed eligible for STB maximum rate regulation because the traffic moved at R/VC ratios greater than 180%. This traffic constituted { } of BNSF's regulated traffic and produced { } in net revenues. *See* Crowley/Fapp Rebuttal V.S. at 12-13.

Thus, despite its repeated protestations to the contrary, it is clear that thousands of shipments, involving billions of dollars in rail commerce, are presumed eligible for STB rate regulation.[7]

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[7] Coal Shippers/NARUC note that, historically, many captive shippers with meritorious maximum rate case claims have not presented those claims to the Board due to their concerns about the cost and length of STB maximum rate proceedings, and fears of railroad retaliation. *See, e.g., Railroad Regulation, Current Issues Associated with the Rate Relief Process* (GAO/RCED-99-46) (Feb. 1999) at 48-49 (General Accounting Office (now the Government Accountability Office) found that the complexity and costs of adjudicating rate cases, length of proceedings, and fear of retaliation were "significant barriers that kept [shippers] from filing . . . rate complaints."). The STB has endeavored to address cost and complexity issues in its recent decisions establishing maximum rate standards and reducing filing fees. *See Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1) (STB served Oct. 30, 2006); *Simplified Standards for Rail Rate Cases*, STB Ex Parte No. 646 (Sub-No. 1) (STB served Sept. 5, 2007); *Regulations Governing Fees for Services*, STB Ex Parte No. 542 (Sub-No. 18) (STB served July 7, 2011).

B. Inclusion of the Premium in BNSF's URCS Will Significantly Reduce the Number of Shippers That Can Seek Maximum Rate Relief from the STB

Coal Shippers/NARUC demonstrated in their Opening Evidence that inclusion of the premium in BNSF's URCS would significantly increase BNSF's variable costs, which in turn would significantly increase the 180% R/VC jurisdictional threshold ratio. Coal Shippers/NARUC Op. at 14-17. Coal Shippers/NARUC also demonstrated that one result of this increase was that a significant amount of traffic that is subject to STB maximum rate regulation – because the traffic currently moves at levels above the 180% threshold – would fall below the 180% threshold and, as a result, would not be subject to STB maximum rate regulation. *Id.* at 14-15.

For example, Crowley/Fapp estimated using publicly available data that shippers tendering 122,699 revenue carloads of freight in 2010 moving at R/VC ratios greater than 180% would move at R/VC ratios less than 180% if the premium was included in BNSF's 2010 URCS. Crowley/Fapp Op. V.S. at 10. BNSF witnesses Baranowski and Fisher ("Baranowski/Fisher") also estimated that shippers tendering in excess of {   } revenue carloads of freight in 2010 currently moving at ratios greater than 180% would move at R/VC ratios less than 180% if the premium is included in BNSF's 2010 URCS. Baranowski/Fisher Op. V.S. at 5-6; Baranowski/Fisher Reply V.S. at 4.

BNSF claims that automatically shutting the regulatory door to shippers tendering over 100,000+ carloads annually is not significant because this change affects "only 1.35% of BNSF's traffic base." BNSF Reply at 13. However, the pertinent statistical inquiry is how much regulated traffic the change affects. BNSF's own workpapers show that { } of BNSF's regulated traffic base is affected. Simply stated, shippers tendering { } of BNSF's traffic will automatically lose their current right to seek rate relief from the STB simply because BNSF's ownership has changed hands. The removal of 100,000+ carloads of traffic annually { } of BNSF's regulated traffic base is both significant and contrary to Congressional intent.

As stated in a letter that ten United States Senators sent to the STB earlier this year:

> If the purchase of a railroad includes an acquisition premium over book value and the railroad is allowed to revalue its property and equipment costs upward to reflect that premium, then the variable cost calculation will increase and the likelihood that shippers will be able to show that rates exceed 180 percent of variable costs will decrease. *We do not think this is what Congress intended when it established this threshold.*

Letter from Senator Al Franken, Senator David Vitter, Senator Tom Harkin, Senator Herb Kohl, Senator Tim Johnson, Senator Mary L. Landrieu, Senator Mark L. Pryor, Senator Michael B. Enzi, Senator Amy Klobuchar, and Senator Jon Tester to STB Chairman Daniel L. Elliott, III (dated Mar. 22, 2011) at 1 (emphasis added).

The bottom line is that many captive shippers who pay rates in excess of those permitted under STB standards will lose their right to pursue relief before the Board, and, as a result, pay higher freight rates than they otherwise would have paid if their rights to regulatory redress had not been artificially stripped from them because Berkshire paid a premium to acquire BNSF.

C. Inclusion of the Premium in BNSF's URCS Will Significantly Increase the Maximum Rates the Board Can Prescribe

Inclusion of the $8.1 billion premium in BNSF's URCS will significantly increase the maximum rates the Board can prescribe in several different ways.

First, in all cases the STB sets maximum rates at the greater of the 180% jurisdictional floor or the highest rates permitted under the Board's rate reasonableness standards. *See* Coal Shippers/NARUC Op. at 15. BNSF concedes that premium-infused variable costs drive up the jurisdictional floor, but says this is unimportant because there have been "only a few instances where the jurisdictional threshold has served as a floor on maximum rate prescriptions." Baranowski/Fisher Reply V.S. at 4.

In fact, the Board frequently prescribes the 180% jurisdictional threshold as the reasonable maximum. Since 1996, the Board has entered rate prescription orders in 10 large rate cases. In five of those ten cases (50%), the Board held that a carrier's tariff rates could not exceed the 180% jurisdictional threshold, with the most recent ruling coming in November 2011:

Case	Date Decided
West Tex. v. BNSF	May 1996
WPL v. UP	May 2002
KCPL v. UP	May 2008
OGE v. UP	July 2009
AEPCO v. BNSF & UP	November 2011

See Rail Rate Cases at the STB (1996 to Present) (located at http://www.stb.dot.gov/stb/industry/Rate_Cases.htm).[8] Inclusion of the premium in BNSF's URCS will automatically increase all BNSF rates prescribed at the jurisdictional threshold level.

Second, in large and mid-size rate cases where the SAC exceeds the jurisdictional threshold, and the complainant shipper is entitled to rate relief, the Board now prescribes SAC relief in the form of a maximum R/VC ratio determined using the Board's Maximum Mark-Up Methodology ("MMM"). BNSF contends that inclusion of the premium in BNSF's URCS will have no adverse impact on shippers obtaining new rate prescriptions under MMM. *See* BNSF Reply at 16. This contention is based on a hypothetical prepared by Baranowski/Fisher. *See* Baranowski/Fisher Reply V.S. at 6-8. However, like most BNSF hypotheticals, the assumptions drive the desired answer. Crowley/Fapp restate Baranowski/Fisher's hypothetical, using different assumptions, and demonstrate that use of premium-infused variable costs produces higher maximum MMM rates. *See* Crowley/Fapp Rebuttal V.S. at 20-24.

Third, in small rate cases where application of the Board's Three Benchmark test results in maximum R/VC ratios above the jurisdictional threshold, the Board prescribes the maximum Three Benchmark R/VC ratio. BNSF concedes that inclusion of the premium in its variable costs will jack-up the resulting maximum Three

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[8] In addition, "[i]n two recent SAC decisions involving BNSF, the Board has prescribed rates that exceed the jurisdictional floor by relatively small amounts." Statement of BNSF regulatory counsel Samuel M. Sipe, Jr., STB Ex Parte No. 657, *Rail Rate Challenges Under the Stand-Alone Cost Methodology* (Public Hearing Testimony filed Apr. 20, 2005) at 2.

Benchmark R/VC ratios, but claims that the Board should ignore this result because it is not subject to any current Three Benchmark R/VC ratio prescriptions. Baranowski/Fisher Reply V.S. at 9. Of course, BNSF is not subject to any Three Benchmark prescriptions because the first small rate case filed against BNSF has not been decided yet by the Board.[9]

BNSF also argues that any premium-generated increases in maximum Three Benchmark R/VC ratio prescriptions will be "small." BNSF Reply at 16. However, that is not the case. Crowley/Fapp show that the impact of the premium will be very significant in Three Benchmark cases. They provide one example showing that a small shipper's available relief is reduced by { } if the premium is included in a 2010 Three Benchmark rate prescription and a second example showing a { } reduction in a rate prescription if the premium is included in a 2013 rate prescription. Crowley/Fapp, Rebuttal V.S. at 13-15.

D. Inclusion of the Premium in BNSF's URCS Will Raise Rates Captive Shippers Can Obtain in Commercial Negotiations

The Board developed its maximum rail rate standards not just for the Board's use in rate litigations, but also for use in captive shipper/railroad contract negotiations. *See* Coal Shippers/NARUC Reply at 16-17. The Board has repeatedly encouraged captive shippers, and their railroads, to negotiate contracts using the Board's maximum rate standards as pricing guides. *Id.* This makes sense because if a deal is not

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[9] *Canexus Chems. Canada L.P. v. BNSF Ry.*, STB Docket No. 42132 (filed Nov. 14, 2011).

reached, and litigation ensues, the Board will set the rates using its maximum rate standards.

Captive shippers routinely follow the Board's guidance. They prepare contract offers using the STB's maximum rate standards as guides, and then present them to carriers in their commercial negotiations. Carriers do the same, and deals are and can be done without the need for litigation. Including the premium in BNSF's URCS will increase the rates shippers will be able to negotiate.

BNSF contends that these adverse changes for captive shippers are not germane because BNSF sets rates based on "market demand," not STB ratemaking standards. Lanigan V.S. at 6-7. It is important to emphasize that BNSF's position is one that the carrier has appeared to have manufactured solely for use in this case. In other proceedings before the Board BNSF has taken the exact opposite position.

For example, Mr. Lanigan, BNSF's Chief Marketing Officer, asserts in this case that "BNSF's policy is to set its rates based on market conditions." Lanigan Reply V.S. at 2. However, as Coal Shippers/NARUC emphasized on Reply (*id.* at 17-18), in 2005, Mr. Lanigan informed the Board that BNSF "often" looks to STB maximum rate standards in setting rates on its captive coal traffic:

> BNSF must consider the large amounts of revenue at risk when it makes pricing decisions. Coal shippers are sophisticated customers of rail transportation service. They regularly threaten to file rate litigation in our contract discussions in an effort to obtain rate concessions. BNSF has taken these threats seriously. . . . BNSF has often sought to avoid the substantial risks of litigation by agreeing to reduced rates in contract negotiations.

Statement of John P. Lanigan, STB Ex Parte No. 657, *Rail Rate Challenges Under the Stand-Alone Cost Methodology* (Public Hearing Testimony filed Apr. 20, 2005) at 3.

Mr. Lanigan's position, as he espoused it in 2005, correctly reflects the actual workings of the marketplace for coal transportation. *See* Crowley/Fapp Rebuttal V.S. at 15-16. Captive coal shippers do rely on the Board's maximum rate standards in their commercial rate discussions with BNSF; BNSF listens to the shippers' rate offers; and then "often" sets rates to avoid maximum rate litigation.

BNSF representatives have also repeatedly emphasized in their recent submissions to the Board that they know and understand that "the Board is relying increasingly on URCS variable cost calculations and revenue-to-variable cost ('R/VC') ratios to assess the reasonableness of rail rates." BNSF's Additional Comments, *Review of the STB's General Costing System*, STB Ex Parte No. 431 (Sub-No.3) (filed June 1, 2009) at 2; *id.*, Testimony of Richard E. Weicher, STB Hearing Transcript (dated April 30, 2009) at 122 ("Whether it's the simplified SAC cases, the three benchmark standard or your average total cost methodology in coal cases, [URCS is] permeating everything."). *See* Coal Shippers/NARUC Reply at 26-28.

The bottom line for captive coal shippers in commercial negotiations with BNSF is analogous to the bottom line for shippers litigating cases at the Board: inclusion of the premium will increase the prices they may be able to negotiate with BNSF using the STB's maximum rate standards.

II.

IT IS FUNDAMENTALLY UNFAIR FOR CAPTIVE SHIPPERS' RATES TO INCREASE SIMPLY BECAUSE BNSF'S OWNERSHIP HAS CHANGED HANDS

Alternatively, BNSF argues that even if captive shippers' rates increase due to its inclusion of the $8.1 billion premium in its URCS, this result is permissible because (1) premium-infused costs are more "accurate;" (2) basic principles of regulatory fairness have no application to rail rate regulation; and (3) past precedent requires the Board to include the premium in BNSF's URCS. Each of these three contentions is fundamentally flawed and wrong.

A. BNSF's Fundamentally Flawed Argument That "Accuracy" Trumps Fairness Is Wrong

BNSF repeatedly argues that there is nothing "'unfair'" about including the $8.1 billion premium in BNSF's URCS because the written-up asset base assertedly reflects the most "economically accurate asset values." BNSF Reply at 2, 11, 20, 24; Dr. Roman L. Weil ("Weil") V.S. at 3-4; Kolbe/Neels V.S. at 20; Baranowski/Fisher Reply V.S. at 4.

BNSF's claims that "accuracy" trumps fairness are misguided. As Dr. Verrecchia demonstrates, both acquisition costs and historic costs (sometimes referred to as "predecessor costs") are equally "accurate," but produce different results because they are measuring different costs:

> Predecessor accounting and GAAP purchase accounting both produce "accurate costs" from an accounting standpoint, assuming each cost is correctly calculated. As applied here, and again assuming the costs were correctly

> accounted for, the net asset values recorded by BNSF prior to its acquisition by Berkshire reflect an "accurate" net cost that BNSF incurred to acquire the assets and the net asset values recorded by Berkshire after its acquisition of BNSF, which have been pushed down to BNSF, reflect an "accurate" net cost that Berkshire incurred to acquire BNSF. The two sets of "accurate" costs produce different net investment values because they are accurately measuring two different things: one is measuring predecessor costs, and the second is measuring acquisition costs.

Verrecchia Rebuttal V.S. at 2.

Crowley/Fapp reach the same conclusion:

> The "accuracy" of the numbers in the 2010 R-1 submitted to the STB is not an issue raised by Coal Shippers/NARUC in this proceeding. The costs before the acquisition premium were "accurate" and the costs after including the acquisition premium are also "accurate," assuming the costs associated with revaluing of the BNSF were done correctly. However, the two calculations are different measures of BNSF's costs. Pre-acquisition costs reflect economic value of assets devoted to public use while the valuation after the Berkshire acquisition reflects the new market value of those assets.

Crowley/Fapp Rebuttal V.S. at 6.

Similarly, the issue of whether to include the premium in BNSF's URCS net investment base turns on policy considerations, not whether one set of costs is more "accurate" than another. If the Board's policy goal is to have the URCS net investment base reflect current market values, then inclusion of the premium write-up is a fair regulatory outcome. However, "if the Board's policy goal is to protect captive rail shippers from having to pay higher rates simply because the ownership of BNSF changed hands, the Board should exclude the $8.1 billion premium from BNSF's [URCS] net investment base." Verrecchia Rebuttal V.S. at 2.

B. BNSF's Fundamentally Flawed Argument That Basic Principles of Regulatory Fairness Have No Application to Railroads Is Wrong

Coal Shippers/NARUC demonstrated in their Opening Evidence that public utility regulators do not permit the pass-through of acquisition premium costs to consumers unless the transaction produces offsetting benefits to consumers. *See* Coal Shippers/NARUC Op. at 24-31; Wilson Op. V.S. at 1-23. These rulings are grounded in four basic principles of fundamental fairness to utility customers:

- **Principle 1 (Ownership Change)** – "a mere change in ownership should not result in an increase in the rate for service *if the basic service rendered itself remains unchanged.*" *Williston Pipeline Co.*, 21 FERC ¶ 61,260, 61,634 (1982) (internal citation omitted), *aff'd on this point sub nom. Farmers Union Cent. Exch. v. FERC*, 734 F.2d 1486, 1527-28 (D.C. Cir. 1984).

- **Principle 2 (No Double Payment)** – a utility customer should not have to double pay for an asset's inflation, "once by . . . including the risk of inflation in the [rate of return] component of rates and again by including inflated value in an acquisition premium adder to [the] rate base." Wilson Op. V.S. at 14.

- **Principle 3 (Capital Devoted to Public Service)** – utility customers should pay only for the original cost of utility assets because the original cost is "'a contribution of capital to the public service,'" whereas a premium paid to acquire the same assets "'does not represent a contribution of capital to the public service.'" *Id.* at 21 (quoting James C. Bonbright, *et al.*, *Principles of Public Util. Rates* (2d ed. 1988).

- **Principle 4 (Circularity)** – allowing premium recovery promotes utility purchasers to pay inflated above-market prices for utility assets in hopes of recovering inflated returns from ratepayers. *See* Wilson Op. V.S. at 7-8.

BNSF argues that these four fairness principles are really just one principle – circularity – and that they have no application to railroad regulation because circularity is not a concern in the railroad industry. *See* BNSF Reply at 21-25.

Coal Shippers/NARUC demonstrated in their Opening Evidence that BNSF's focus on circularity is misplaced. Public utility regulators routinely reject the pass-through of acquisition premiums in cases where there are *no* circularity concerns because the utility is purchased in an arm's length transaction at a fair (not gamed) price. *See* Coal Shippers/NARUC Op. at 29. They do so because the transaction violates other principles of regulatory fairness at issue in a particular acquisition, *i.e.*, requiring customers to pay higher rates for the same service, requiring customers to pay for the same assets twice, or requiring customers to pay returns on investments not devoted to public service.

As summarized by one utility regulatory commission:

> We believe that before an acquisition adjustment may be granted there must be more than a simple showing that an arms-length transaction was involved, or that the price for the acquired system was reasonable under the circumstances. Above all, there must be a showing that the ratepayers will benefit substantially from the acquired system and that the purchase price is justified in terms of improvement in service it will bring about for the ratepayers. Since the Company has failed to present affirmative evidence of any aspect of the acquisition adjustments, much less benefit to the ratepayers,

> we find that . . . the acquisition adjustments . . . should be disallowed.

In re Application of Seacoast Utils., Inc., No.13317, 1984 WL 918759 at *4 (Fla. P.S.C. May 21, 1984).[10]

Since BNSF's Reply simply avoids this demonstration, Coal Shippers/NARUC again emphasize it on rebuttal. As summarized by Dr. Wilson:

> As I discussed in my OVS, FERC and other public utility regulators routinely reject pass-throughs of acquisition premiums to captive customers in cases where there are no gamed prices, or circularity concerns. The reason why this is

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[10] *Accord In re The Detroit Edison Co.*, Case No. U-15244, 2010 WL 2244097 at *6 (Mich. P.S.C. Jan. 25, 2010) (acquisition premium recovery denied because of utility's "failure to substantiate that . . . the premium generated synergy savings that provide a net benefit to . . . ratepayers"); *In re Thunder Bay Gathering Co.*, No. U-14672, 2007 WL 674615 at *10 (Mich. P.S.C. Feb. 14, 2007) (rejecting premium pass-through because utility had not shown any "benefit to ratepayers resulting from [the involved] purchase"); *In re Citizens Utils. Co.*, No. 90-0405, 1991 WL 497470 at *6 (Ill. Commerce Comm'n Sept. 18, 1991) (rejecting argument that acquisition premium is permitted automatically if purchase is at "arm's length"); *In re Application of Heater Utils., Inc.*, No. W-274, SUB 567, 2006 WL 2595328 at 4 (N.C. Utils. Comm'n Aug. 30, 2006) (same); *In re Nat'l Grid plc*, No. D.P.U. 07-30, 2010 WL 2572543 at *15 (Mass. D.P.U. June 9, 2010) ("any acquisition premium is permitted only to the extent that there are any [ratepayer] benefits resulting from the merger"); *In re Va. Natural Gas, Inc.*, No. PUE-2005-00062, 2006 WL 2346368 at *7 (Va. S.C.C. July 24, 2006) (premium pass-through permitted only if purchase price was determined in "arms-length bargaining" and, among other things, produces "cost saving benefits to consumers"); *In re UtiliCorp United Inc.*, No. EM-2000-292, 2004 WL 431561 at *4 (Mo. P.S.C. Feb. 26, 2004) (no premium pass-through permitted for "reasonable" acquisition price paid in "arms-length transaction" because "it is the responsibility of [the utility's] shareholders to pay any acquisition premium"); *In re Citizens Commc'ns Co.*, No. 02-0060, 2002 WL 31319459 at *4, *11 (Haw. P.U.C. Sept. 17 2002) (rejecting pass-through of acquisition premium in case where the "purchase price is fair and reasonable and is supported by the arms-length negotiations between [the involved parties]"); *In re Westfield Gas Corp.*, No. 43624, 2010 WL 1003185 at *15 (Ind. U.R.C. Mar. 10, 2010) ("acquisition adjustments are only allowed in cases of demonstrated benefits subsequent to acquisition, or improvements to a troubled utility").

> true is that circularity is simply one test, but not the exclusive test, used by FERC and other public utility regulators in addressing acquisition premium pass-through issues. For example, a principal test that FERC and many other public utility regulators use to determine whether to allow premium pass-throughs is whether the premium is off-set by new consumer benefits that are enabled by the payment of the acquisition premium. If there are no offsetting benefits, acquisition premium pass-throughs are not permitted based on the fundamental public policy that captive customers should not have to pay higher rates simply because the ownership of the utility has changed hands, and the new owners paid a premium for the same set of utility assets and consumer benefits that existed before the acquisition. This test assumes that there is no gamed purchase price, since if the price had been gamed, the premium pass-through would have been rejected on that ground alone.

Wilson Rebuttal V.S. at 10-11 (citation omitted).

The result here is clear: no federal or state agency would permit the pass-through of acquisition premiums to captive customers in a case where the customers' service remains unchanged, they are required to pay twice for the same asset, and they are required to pay a premium that is not devoted to public service. All of these principles are rooted in fundamental notions of regulatory fairness to utility customers, and these principles apply with equal force regardless of whether the utility is an electric company, a pipeline, a railroad or any other regulated entity and the regulator is FERC, a state regulatory commission, or the STB.

The STB should apply these basic principles of regulatory fairness in this case. The reason why shippers, USDA, all Congressional representatives that have weighed-in in this proceeding, and NARUC oppose the inclusion of the \$8.1 billion premium in BNSF's URCS is clear: it is unfair to BNSF's captive customers to pay higher rates simply because Berkshire paid a huge premium to acquire BNSF.

C. BNSF's Fundamentally Flawed Argument that "Precedent" Governs the Unique Berkshire Acquisition Is Wrong

BNSF argues that "precedent" supports the Board's inclusion of the $8.1 billion premium in BNSF's URCS (BNSF Reply at 2, 5, 7) and that Coal Shippers/ NARUC bear a "heavy burden" to overturn this precedent, which they assertedly have not met (*id.* at 4). These assertions are incorrect. The Board judges premium issues on a case-by-case basis to determine the "reasonable valuation in each particular case."[11] In this case, exclusion of the $8.1 billion premium from BNSF's URCS is the "reasonable valuation," and one that is fully supported by Board precedent.

1. The Board's Merger Case Precedent Supports Exclusion of the Premium from BNSF's URCS

The Board has approved many large rail mergers or acquisitions where the acquirer has paid a premium to purchase the target railroad, including *Conrail,*[12] *UP/SP,*[13]

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[11] *Railroad Revenue Adequacy – 1988 Determination*, 6 I.C.C. 2d 933, 941 (1990), *aff'd sub nom. Ass'n of Am. R.R. v. ICC*, 978 F.2d 737 (D.C. Cir. 1992). The reviewing court specifically referenced the ICC's "pledge" to engage in case-by-case review of premium issues, and relied on that "pledge" in affirming the ICC's decision. *See id.*, 978 F.2d at 245. Also, in undertaking its case-by-case review, the Board is required to consider "new evidence or different arguments" not presented in prior cases (*Carolina Power & Light Co. v. Norfolk S. Ry.*, 7 S.T.B. 235, 246 (2003)) and is not bound by prior decisions when "faced with new developments." *Am. Trucking Assocs., Inc. v. Atchison, Topeka, & Santa Fe Ry.*, 387 U.S. 397, 416 (1967).

[12] *CSX Corp. – Control & Operating Leases/Agreements – Conrail Inc.*, 3 S.T.B. 196 (1998) ("*Conrail*").

[13] *Union Pac. Corp. – Control and Merger – S. Pac. Rail Corp.*, 1 S.T.B. 233 (1996) ("*UP/SP*").

BN/Santa Fe,[14] and *Blackstone/CNW.*[15] However, in each case, the Board approved the merger or acquisition – including approval of the purchase price that included a premium – on grounds that the transaction was in the public interest because shippers benefited "in the form of lower rates and improved service." *Conrail,* 3 S.T.B. at 249.

Berkshire's acquisition of BNSF is fundamentally different than *Conrail, UP/SP, BN/Santa Fe* and *Blackstone/CNW* because the transaction was not subject to STB (or Interstate Commerce Commission ("ICC")) approval, and more importantly, will not result in "lower rates and improved service." *See* Coal Shippers/NARUC Op. at 33-36. Instead, the Berkshire transaction calls for higher captive shipper rates and no service improvements.

BNSF contends that Coal Shippers/NARUC's demonstration is in error because the ICC/Board did not expressly consider premium issues in *UP/SP*, *BN/Santa Fe*, and *Blackstone/CNW*, and cited lower rates as only one ground for approving the acquisition premium in *Conrail.* BNSF Reply at 7. This argument is an exercise in misdirection because BNSF is really arguing that the ICC/Board would have approved the mergers and acquisitions in *Conrail, UP/SP, BN/Santa Fe* and *Blackstone/CNW* on the facts presented here: no public benefits in the form of service improvements or reduced rates, and substantial public detriments in the form of premium-driven higher captive shipper rates.

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[14] *Burlington N. R.R. Co. – Control and Merger – Santa Fe Pac. Corp.*, 10 I.C.C.2d 661 (1995) ("*BN/Santa Fe*").

[15] *Blackstone Capital Partners L.P. – Control Exemption – CNW Corp. & Chicago & N. W. Transp. Co.*, 5 I.C.C.2d 1015 (1989) ("*Blackstone/CNW*")

Coal Shippers/NARUC submit that the ICC/Board would not – and could not – have approved any major merger or acquisition in the last thirty years if the applicants had come before the Board with a transaction where there were no public benefits, and substantial public detriments. More importantly, the Board could not have approved Berkshire's acquisition of BNSF in its present form because the transaction offered no public benefits, much less the "substantial" public benefits, required under the Board's acquisition rules. *See* 49 C.F.R. § 1180.1(c) (STB will approve rail mergers and acquisitions only when they result in "substantial and demonstrable gains in important public benefits").

While the Board has no jurisdiction to reject Berkshire's acquisition of BNSF, it can act to protect the public interest by removing the premium from BNSF's URCS. In so doing, the Board will be acting in a manner consistent with its acquisition precedent and rules, because it will be eliminating the portion of the transaction that works to the significant detriment of BNSF's captive shippers – the premium.

2. The Board's Ratemaking Precedent Supports Exclusion of the Premium from BNSF's URCS

In the past several years, the Board has fused maximum rates together with regulatory costs. Maximum SAC, maximum Simplified SAC, and maximum Three Benchmark rates are set using R/VC ratios and, in all cases if the SAC, Simplified SAC or Three Benchmark maximum R/VC ratio is less than the jurisdictional threshold of 180%, the maximum rate is set at an R/VC ratio of 180%. *See* Coal Shippers/NARUC Reply at 22-28.

One result of the fusion of costs and rates is that inclusion of the premium in BNSF's URCS flows directly through to each of the Board's maximum R/VC ratios, as well as the jurisdictional threshold. Thus, as Coal Shippers/NARUC have emphasized through-out this proceeding, the Board needs to focus on the bottom line fairness of jacking-up the variable costs used to calculate all of these ratios simply because BNSF's ownership has changed hands.

BNSF continues to argue on Reply, as it has through-out this proceeding, that the issue before the Board is controlled by Generally Accepted Accounting Principles ("GAAP"). *See* BNSF Reply at 1, 2, 4-13, 16, 19-21, 25-29. However, both Coal Shippers/NARUC's expert accounting witness (Dr. Verrecchia) and BNSF's expert accounting witness (Dr. Weil) agree that "GAAP does not require the STB to use any accounting convention for its regulatory purposes." Weil V.S. at 3. Moreover, BNSF also offers no response to the long-established principle that "there is no assurance . . . that reasonable accounting measures translate automatically into reasonable rates." *Farmers Union Cent. Exch. v. FERC*, 584 F.2d 408, 418 (D.C. Cir. 1978). This principle is particular apt here because application of GAAP accounting principles produces grossly unfair results for captive BNSF shippers.

BNSF also continues to rely heavily on the Railroad Accounting Principles Board ("RAPB") *Final Report* (Sept. 1, 1987). *See* BNSF Reply at 2, 4-5, 7, 9, 12, 20-22 24-25, and 27-28. RAPB recommended the use of GAAP acquisition costs, but with one significant caveat that BNSF conveniently ignores: "[w]here the GAAP cost reasonably cannot be viewed as a meaningful regulatory measure of value, other measures of value may be used." *Id.* Vol. 2 at 39.

Similarly, BNSF cavalierly ignores Coal Shippers/NARUC's detailed discussion why it is most unlikely the RAPB, which issued its report nearly 25 years ago, would, if it existed today, approve the massive write-up in BNSF's URCS investment base. The RAPB premised its approval of GAAP acquisition accounting on grounds that variable costs were not "used directly in ratemaking," an assertion that was true at the time, but is not true today. *Id.* at 46. The RAPB also premised its approval of GAAP acquisition accounting on grounds that there were no circularity concerns in the railroad industry because railroads "probably" did not "possess sufficient market power that rates are materially affected by what the regulator allows." *Id.* at 46-47.

As Coal Shippers/NARUC have demonstrated, circularity is just one of several concerns that public utility regulators have with acquisition premiums, so the RAPB's focus just on circularity finds no support in public utility law. In addition, it is now clear that BNSF does have material market power over captive shippers' rates. BNSF's own data shows that { } of its regulated traffic in 2010, from which it collected { } in revenues, moves at rates with R/VC ratios in excess of 180%, and is presumptively eligible for STB maximum rate regulation. *See* Crowley/Fapp Rebuttal V.S. at 12-13.

Finally, BNSF argues that "Congress endorsed the . . . use of GAAP accounting by the STB." BNSF Reply at 28. In fact, Congress has directed that the

Board conform its uniform accounting system to GAAP "[t]o the maximum extent practicable" (49 U.S.C. § 11142) and that the Board adopt cost accounting principles that conform to GAAP "[t]o the maximum extent practicable" (49 U.S.C. § 11161). As discussed above, GAAP does not provide an answer to the question presented in this case – how the Board should value BNSF's URCS net investment base for ratemaking purposes. Even more significantly, every member of Congress that has contacted the STB on this matter has made it very clear that Congress did not intend to permit BNSF to pass through the Berkshire premium to its captive shippers.

III.

THE BOARD HAS THE LEGAL AUTHORITY TO REMOVE THE $8.1 BILLION PREMIUM FROM BNSF'S URCS

Coal Shippers demonstrated that the Board has the authority to adjust BNSF's URCS by exercising its broad authority to adjust URCS variable costs under 49 U.S.C. § 10707(d)(1)(B) and by exercising its equally broad authority over the reasonableness of rail rates on market dominant traffic under 49 U.S.C. §§ 10701(d)(1), 10704(a)(1). *See* Coal Shippers/NARUC Op. at 41-43.

BNSF does not dispute that the Board has the power to exclude the premium from its URCS, but argues that Coal Shippers/NARUC have failed to "show why" the Board should take this action. BNSF Reply at 6. Of course, Coal Shippers/NARUC have shown why the Board should remove the premium from BNSF's URCS.

Unlike all other premium-related cases before the Board, Berkshire's acquisition of BNSF raises unique facts: the acquisition was not approved by the STB, the transaction does not produce any benefits to the shipping public, and, unless the Board removes the premium from BNSF's URCS the transaction will produce very significant adverse consequences for BNSF's captive shippers in the form of reduced access to the Board, and higher rail rates. These facts – which are unlike any seen before in a Board case involving premium issues – require that the Board reach the right and fair result: declare that it will remove the $8.1 billion premium from BNSF's URCS, starting with the 2010 BNSF URCS.

BNSF also does not dispute the fact that inclusion of the premium will significantly increase the rates WFA/Basin Electric will pay under their rate prescription and that the Board has the legal authority to take corrective action in this proceeding. However, BNSF argues that the Board should address the "unique circumstances" of that prescription in the *WFA* rate case.[16] BNSF Reply at 3. WFA/Basin Electric's circumstances are hardly "unique;" they just provide a graphic example of the significant impact inclusion of the premium can have on prescribed maximum rates – tens of millions of dollars in their case.[17]

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[16] *See WFA v. BNSF Ry.* in Docket No. 42088.

[17] In response to the Board's recent decision issuing the 2010 BNSF URCS, WFA/Basin Electric recently made a filing in their rate case to protect their refund rights during the pendency of the instant proceeding. *See* Complainants' Petition Responding to the Board's Order Served on December 9, 2011 in Finance Docket No. 35506 (filed Dec. 14, 2011).

In addition, the Board recently prescribed maximum R/VC ratios in the *AEPCO* rate case.[18] Inclusion of the premium in BNSF's variable costs will also drive up the maximum rates that AEPCO will pay under its prescription. *See* Crowley/Fapp Rebuttal V.S. at 24-25. The Board can and should take action in this case to address the adverse impact premium inclusion has on the *WFA* and *AEPCO* rate case prescriptions.

IV.

THE BOARD SHOULD ALSO REMOVE THE PREMIUM FROM BNSF'S REVENUE ADEQUACY NET INVESTMENT BASE

BNSF observes that shippers in their opening filings in this case "devote relatively few pages" to the issue of removing the premium from BNSF's revenue adequacy base. BNSF Reply at 19. BNSF goes on to argue that there is "good reason" for the shippers' not to address revenue adequacy issues because "[r]evenue adequacy has never been used by the STB or the ICC to set railroad rates." *Id.*

Of course the reason why shippers have seldom invoked the revenue adequacy pricing constraint is because the ICC and the STB have seldom found major railroads to be revenue adequate and, as Coal Shippers/NARUC demonstrated in their Opening Evidence, inclusion of the premium in BNSF's revenue adequacy net investment base produces the ridiculous result that BNSF is deemed less revenue adequate after being purchased at a price far in excess of its pre-acquisition book value. *See* Coal Shippers/NARUC Op. at 46.

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[18] *See Ariz. Elec. Power Coop. v. BNSF Ry. & Union Pac. R.R.*, STB Docket No. 42113 (STB served Nov. 22, 2011).

In their Rebuttal V.S., Crowley/Fapp have reviewed Baranowski/Fisher's revenue adequacy calculations and restated their opening calculations. Crowley/Fapp's restated calculations show that if the premium is excluded from BNSF's revenue adequacy net investment base, and the impact of removing BNSF from the industry average cost of capital is accounted for, BNSF would have been deemed "revenue adequate" in 2010, along with UP, CSX, and NS. *Id.*

The Board should remove the acquisition premium from BNSF's revenue adequacy net investment base for the same reasons that the Board should remove it from the Board's URCS net investment base: BNSF's net investment base for regulatory purposes should not increase, and its return on investment ("ROI"), decrease simply because BNSF's ownership has changed hands. In addition, removal of the premium will avoid ridiculous results: BNSF having a lower regulatory ROI even though its book value has increased dramatically.

Finally, Coal Shippers/NARUC observe that BNSF – not shippers – asked the Board to consider revenue adequacy issues in this proceeding. For the past 30+ years, BNSF has incessantly maintained that revenue adequacy was of paramount importance to it, and to its investors.[19] It is interesting that given the opportunity to actually obtain

[19] *See, e.g.,* Comments of the Ass'n of Am. R.R.'s, *Methodology to Be Employed in Determining the Railroad Industry's Cost of Capital*, STB Ex Parte No. 664 (filed Sept. 27, 2007 ("a finding of revenue adequacy is not merely an academic conclusion" and "could have major implications for the railroads' financial health"); Comments of BNSF Ry., *Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1) (filed May 1, 2006) (BNSF asserts that the Board has a "statutory mandate . . . [to] apply its regulatory authority to assist railroads to become revenue adequate") ("*Major Issues*");

revenue adequacy through proper accounting for its acquisition by Berkshire, BNSF asks for an accounting that will make it revenue inadequate and downplays the importance of the revenue adequacy standard. The Board should keep this in mind the next time BNSF reverses course, and argues that the Board should adopt pro-BNSF regulatory positions due to BNSF's asserted "revenue inadequate" status.

CONCLUSION

For the reasons set forth in their Opening, Reply and Rebuttal submissions, Coal Shippers/NARUC respectfully request that the Board issue a declaratory order excluding the $8.1 billion acquisition premium from BNSF's URCS, starting in 2010, and excluding the premium in calculating BNSF's net investment base for revenue adequacy purposes, starting with the Board's 2010 revenue adequacy determination.

Reply Comments of BNSF Ry., *Major Issues* (filed May 31, 2006) at 2 (BNSF asserts the importance becoming revenue adequate, stressing that "the Board must be guided by its findings that no Class I railroad has become revenue adequate on a sustained basis").

Respectfully submitted,

WESTERN COAL TRAFFIC LEAGUE
AMERICAN PUBLIC POWER ASSOCIATION
EDISON ELECTRIC INSTITUTE
NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS
NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
WESTERN FUELS ASSOCIATION, INC., AND
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Dated: December 20, 2011

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Finance Docket No. 35506

Rebuttal Verified Statement of Dr. John W. Wilson

On behalf of

The Western Coal Traffic League

American Public Power Association

Edison Electric Institute

National Association of Regulatory Utility Commissioners

and

National Rural Electric Cooperative Association

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Finance Docket No. 35506

Rebuttal Verified Statement of Dr. John W. Wilson

I am Dr. John W. Wilson, President of J.W. Wilson & Associates, Inc. I presented a verified statement ("OVS") on October 28, 2011 that was included in the Joint Opening Evidence and Argument filed by The Western Coal Traffic League, American Public Power Association, Edison Electric Institute, National Association of Regulatory Utility Commissioners, National Rural Electric Cooperative Association, Western Fuels Association, Inc., and Basin Electric Power Cooperative, Inc. ("Coal Shippers/NARUC"). My qualifications are set forth in Exhibit A to my OVS.

BNSF's Reply Evidence and Argument ("BNSF Reply") filed with Surface Transportation Board ("STB" or "Board") on November 28, 2011 contains a Joint Verified Statement ("Reply JVS") of A. Lawrence Kolbe and Kevin Neels ("Kolbe/Neels"). Kolbe/Neels discuss my OVS in their joint verified statement. I have been asked by counsel for Coal Shippers/NARUC to respond to Kolbe/Neels discussion of my OVS.

OVERVIEW

In my OVS, I demonstrated that: (1) public utility regulators seldom permit the inclusion of acquisition premiums in regulated utility rate bases; (2) no public utility regulator would permit inclusion of an acquisition premium in a regulated utility's rate base in a case involving facts corresponding to those involved in this proceeding: *i.e.*, an acquisition where a purchaser paid a $8.1 billion dollar premium with no offsetting public benefits to consumers in the form of acquisition synergies; and (3) the reasons why no public utility regulator would permit inclusion of the $8.1 billion premium in a regulated utility rate base apply with equal force in the instant proceeding involving Berkshire Hathaway, Inc.'s ("Berkshire") acquisition of BNSF Railway Company ("BNSF").

I concluded in my OVS, that "consistent with sound principles of public utility regulation, and the uniform application of these principles by all other regulatory bodies with similar responsibilities (in the context of both fully and partially regulated industries), the $8.1 billion acquisition premium should be wholly excluded from BNSF's rate base for ratemaking and other similar regulatory purposes." *Id.* at 4.

In their Reply JVS, Kolbe/Neels, acknowledge that "acquisition premiums are typically excluded from a utility's rate base." *Id.* at 1. However, they argue that "the reasons that an acquisition premium would be excluded [from a utility's rate base] . . . do not apply to industries like rail carriers" (*id.*) and conclude that "[i]t is economically appropriate for the Board to accept BNSF's revalued asset values for regulatory purposes." *Id.* at 2. As I demonstrate below, Kolbe/Neels are wrong. The reasons why FERC and other regulators typically do not permit acquisition premiums to be recovered from utility rate payers apply with equal force in this case.

I.

UTILITY CUSTOMERS' RATES SHOULD NOT INCREASE SIMPLY BECAUSE A NEW OWNER PAID AN ACQUISITION PREMIUM

Virtually all utility regulators, including FERC, as well as other federal regulators and state regulators, are charged with setting "reasonable" rates in markets where the utilities exert substantial market power.[1] In exercising this authority, FERC and other regulators typically do not permit acquisition premiums to be included in regulatory rate bases to be recovered from utility customers.

The reason for this exclusion is premised on basic "just and reasonable" principles of regulatory fairness to utility customers: "a mere change in ownership should not result in an increase in the rate for service *if the basic service itself remains unchanged*."[2] *See* OVS at 15-17. This result also ensures that utility customers are not required to pay for the inflated value of an asset twice: once through allowed returns (including inflation adders) paid to the original asset owner and a

[1] See, e.g., 16 U.S.C. §§ 824, 824d, 824e (providing that rates and charges for the transmission of electric energy in interstate commerce by public utilities, and the sales of electric energy at wholesale in interstate commerce by public utilities "shall be just and reasonable"); 15 U.S.C. §§ 717, 717c, 717d (providing that the pipeline transportation of natural gas in interstate commerce, and the sale in interstate commerce of natural gas for resale for public consumption "shall be just and reasonable"); 49 U.S.C. § 60502 (transferring to FERC former duties of ICC, including the responsibilities of former Interstate Commerce Act §1(5)(b), providing that the rates for common carrier pipeline transportation of oil in interstate commerce shall be just and reasonable); see also James C. Bonbright et al., *Principles of Public Utility Rates, Second Ed.*, Ch. 3 ("It is a general doctrine of American law, almost universal in its application to public utility companies . . . that these companies are under a duty to offer adequate service at reasonable (or just and reasonable) rates.").

[2] *Williston Pipeline Co.*, 21 FERC ¶ 61,260, 61,634 (1982).

second time through an inflated acquisition cost. It also precludes recovery of premium amounts which "do not represent a contribution to capital to the public service."[3]

Kolbe/Neels argue that these principles do not govern here because of asserted differences between how FERC and other public utility regulators regulate and how the STB regulates. However, the asserted differences that Kolbe/Neels cite are either wrong or not material. The bottom line here is that the change in BNSF's ownership should not result in increased rail rates for captive BNSF customers since BNSF's service and customer benefits remain unchanged.

- Kolbe/Neels contend that differences in the "FERC and STB regulatory regimes" make FERC premium precedents inapposite. Reply JVS at 3. However, that is not correct. FERC has been directed by Congress to set just and reasonable rates on utility services subject to its regulatory jurisdiction. In exercising that jurisdiction, FERC sometimes grants "market rate authority" and allows electric utilities to set market-based rates for wholesale power generation in markets where sellers have applied for market rate authority and have satisfactorily demonstrated that there is effective competition, and it sets regulated rates in markets where sellers have not applied for market-based rate authority and satisfactorily demonstrated the prevalence of effective competition. The STB's regulatory jurisdiction over rates parallels FERC's. The STB does not exercise ratemaking authority over rates in competitive rail markets. Instead, the STB's maximum rate jurisdiction is limited to markets where there is an absence of effective transportation competition.

[3] See James C. Bonbright et al., *Principles of Public Utility Rates, Second Ed.*, at 238-40.

- Kolbe/Neels contend that FERC regulates rates in non-competitive markets using "cost-of service … rates based on original cost" rate base, which they refer to as "OC regulation" whereas "[i]n the rail sector, there is no 'rate base' for rate regulation purposes" and the STB sets rates using "market-based principles." Reply JVS at 4. Kolbe/Neels discussion of governing STB ratemaking principles is incorrect.

The STB currently sets maximum rail rates on all traffic at specified R/VC ratios. The maximum ratios reflect both cost and market factors, but in the end are set as R/VC ratios. The variable costs used to calculate these ratios are determined using the Board's Uniform Railroad Costing System ("URCS"). As Coal Shippers/NARUC have explained, URCS variable investment costs include a current cost of capital return on a carrier's net investment base. This net investment base is calculated using the following formula: gross investment – accumulated depreciation + working capital – deferred taxes. Coal Shippers/NARUC Op. at 12.

Thus, URCS does contain a net investment base, and the issue in this case is whether BNSF's net investment base, as used in URCS, should be written up to include the $8.1 billion acquisition premium, which in turn will raise rates for captive customers in STB rate proceedings, or in commercial negotiations where captive customers are relying on the STB's maximum rate standards to moderate monopoly carrier rail pricing.

This is exactly the same issue that arises when FERC or other regulators use a rate base/rate of return method to set captive customers utility rates: should the rate base be increased to reflect acquisition premiums. Public utility law and regulatory precedent are clear that premiums should not be included unless there are offsetting benefits or synergies. Here, as I understand it, BNSF has not claimed that its acquisition by Berkshire has produced any synergies, so, consistent with unexceptionable regulatory principles in all jurisdictions, there should be no inclusion of the premium in BNSF's URCS net investment base.

I also understand that the STB makes annual revenue adequacy determinations where the STB compares a carrier's net return on investment ("ROI") to the ROI the carrier would need to equal the average cost of capital of large railroads. I also understand that the STB uses these revenue adequacy determinations in developing maximum reasonable rates under its Three-Benchmark R/VC ratio test used in small rate cases and that the Board's large rate case standards call for limitations on rail pricing for carriers deemed revenue adequate by the STB. Coal Shippers/NARUC Op. at 17-19.

Coal Shippers/NARUC explained in their opening presentation that the Board calculates a rail carrier's net investment for revenue adequacy purposes in the same general fashion that it uses in URCS, with the net investment base equaling: gross investment – accumulated depreciation + working capital – deferred taxes. *Id.* at 17-18. The $8.1 billion acquisition premium should be excluded from BNSF's net investment base for the same reasons it should be excluded from BNSF's URCS net investment base: inclusion is unfair to regulated rail shippers.

- Kolbe/Neels argue that "OC regulation cannot be used in industries facing material competition." Reply JVS at 6. This contention is a red herring in this case. Coal Shippers/NARUC are not advocating that the Board use what Kolbe/Neels call "OC" regulation in this case, *i.e.* to require that rates on competitive rail traffic be set by "OC" or any other form of regulation.

As discussed above, the STB only has regulatory jurisdiction over rail transportation where a shipper is captive to one or more rail carriers. Coal Shippers/NARUC are asking the Board to exclude the $8.1 billion acquisition premium from the net investment base the Board uses to set maximum rates under its current maximum rate standards for captive shippers.

Moreover, Kolbe/Neels' assertion that "OC regulation cannot be used in industries facing material competition" is categorically incorrect when applied to FERC or other federal and state regulation. FERC routinely applies what Kolbe/Neels refer to as "OC" regulation to industries it regulates to set utility rates in markets where there is no effective competition, while permitting these same utilities to charge market rates in markets where there is effective competition. The same is true in other regulated markets and in regulatory practice by State regulatory commissions. For example, there has long been "OC" regulation of certain telephone service rates, while, at the same time, other competitive telephone service offerings by the same companies using the same facilities are sold at market prices

One particularly pertinent example of the application of "OC" regulation in markets where there is no effective competition, while permitting market rates where there is effective competition is provided by FERC's decision in *Duke Energy Moss Landing, LLC*, 83 FERC ¶ 62,297 (1998) ("*Moss Landing*"). That case involved generating units purchased by Duke Energy from another utility. These units produced power that at certain times (called "must-run" time periods) was sold at rates subject to "cost-based regulation" whereas at other times the power produced at the same units was sold at deregulated "market-based rates." *Id.* at ¶ 62,304. This case provides a graphic example of FERC applying cost-based regulation to a utility that also faced material competition.

Also, of particular significance to the instant proceedings, Duke Energy paid an acquisition premium for some of the involved units and asked FERC for permission to include recovery of the premium in its cost-based rates for these units. FERC denied this request, holding that Duke Energy should recover the premium from its competitive customers as part of its market-based rates, not from its captive customers as part of its regulated rates. *Id.* at ¶ 62,305.

FERC's rationale for excluding the premium from the regulated rate base was simple and straightforward: a utility that has been given freedom to set deregulated market rates has "the opportunity to recover its acquisition premium through its market-based rates" and, as a matter of public policy, collecting acquisition premiums from competitive customers is preferable to collecting premiums from captive customers. *Id.* FERC also noted that Duke Energy had not demonstrated that transaction benefits would offset the premiums. *Id.* at n. 41.

Finally, FERC rejected Duke Energy's contentions that precluding recovery of acquisition premiums from captive customers would "discourage divestitures":

> We also disagree with Duke Energy's argument that our summary rejection of the proposed acquisition adjustment will have a chilling impact on divestitures. It is market forces that are driving those divestitures, and a buyer's economic decision to purchase generating units is driven by the rates that it hopes to receive for sales from the units. When a potential purchaser knows, as here, that the units to be purchased will be operated in a must-run (market power) condition part of the time, and therefore that a cost-based cap will be imposed part of the time, but that it will be able to sell power at market-based rates the remainder of the time, its economic decision to purchase the generating unit at a price above book value is based on its perception of the "profitability" of the unit in making sales at market-based rates. We do not believe that the denial of an acquisition adjustment, in a situation in which a buyer will be able to sell power at market-based rates at least part

> of the time, will discourage divestitures. Instead, it will merely signal that bid prices above book value should be based on an assessment of the potential risks and rewards associated with the asset in a competitive market.

Id. (footnotes omitted).

The principles espoused by FERC in *Moss Landing* apply with equal force to Berkshire's acquisition of BNSF. Like Duke Energy, BNSF operates in both competitive and captive markets. Also, like Duke Energy, BNSF has the opportunity to recover the premiums paid to acquire it through its pricing of non-captive traffic. *Moss Landing* teaches that companies that operate in both regulated and unregulated markets should recover premiums from unregulated competitive markets (where customers have service choices) not from captive customers (who do not), particularly in cases where the acquisitions do not produce new benefits for captive customers that offset the premiums.

II.

UTILITY REGULATORS ROUTINELY REFUSE TO PERMIT THE PASS THROUGH OF ACQUISTION PREMIUMS TO CAPTIVE CUSTOMERS EVEN WHERE THERE ARE NO "CIRCULARITY" CONCERNS

BNSF appears to take the position that the *exclusive* test applied by FERC and other public utility regulators to determine whether acquisition premiums may be included in rate bases involves "circularity": *i.e.*, whether a utility purchaser paid more for a utility asset than its original cost with the expectation that it would be able to charge higher prices to captive customers than the rates it would be able to charge if it paid a lower acquisition price. See BNSF Reply at 21-25.

That argument is simply wrong. Certainly, FERC and other public utility regulators will reject the recovery of acquisition premiums where it appears the purchaser is trying to game the regulatory process by paying inflated prices for a utility asset in hopes of obtaining approval to charge artificially inflated rates to captive utility customers.[4] See OVS at 6-8. However, if circularity was the only concern that FERC and other public utility regulators had with utility acquisitions and mergers, the sole test they would apply in reviewing such transactions would be one focused on determining whether the purchaser paid a price for the asset that was above original cost. Of course, that is not what FERC and other public utility regulators actually do.

As I discussed in my OVS, FERC and other public utility regulators routinely reject pass-throughs of acquisition premiums to captive customers in cases where there are no gamed prices, or circularity concerns. The reason why this is true is that circularity is simply one test, but not the exclusive test, used by FERC and other public utility regulators in addressing acquisition premium pass-through issues. For example, a principal test that FERC and many other public utility regulators use to determine whether to allow premium pass-throughs is whether the premium is off-set by new consumer benefits that are enabled by the payment of the acquisition premium. If there are no offsetting benefits, acquisition premium pass-throughs are not permitted based on the fundamental public policy that captive customers should not have to pay higher rates simply because the ownership of the utility has changed hands, and the new owners paid a premium for the same set of utility assets and consumer benefits that existed before the

[4] *Minnesota*, 43 FERC ¶ 61,502, 61,342 (1988).

acquisition.[5] This test assumes that there is no gamed purchase price, since if the price had been gamed, the premium pass-through would have been rejected on that ground alone. As one utility regulatory commission summarized:

> We believe that before an acquisition adjustment may be granted there must be more than a simple showing that an arms-length transaction was involved, or that the price for the acquired system was reasonable under the circumstances. Above all, there must be a showing that the ratepayers will benefit substantially from the acquired system and that the purchase price is justified in terms of improvement in service it will bring about for the ratepayers. Since the Company has failed to present affirmative evidence of any aspect of the acquisition adjustments, much less benefit to the ratepayers, we find that . . . the acquisition adjustments . . . should be disallowed.

In re Application of Seacoast Utilities, Inc., No. 13317, 1984 WL 918759 at *4 (Fla. P.S.C. May 21, 1984).

A good example of the application of the public benefits test, and one I discussed in detail in my OVS, was Berkshire's acquisition of Pacificorp through its Mid-American subsidiary. In that case, Berkshire's subsidiary paid a significant premium to acquire Pacificorp, but there were no claims that the price was a gamed above-market price, and Berkshire's subsidiary did not claim that the premium was offset by any benefits to captive utility customers. On these facts, the Berkshire subsidiary conceded that it could not seek acquisition premium recovery from captive

[5] See, e.g., *Transcontinental Gas Pipe Line Corp. v. FERC*, 652 F.2d 179, 180 (D.C. Cir. 1981) (FERC decision to deny acquisition premium pass-through where there were no demonstrated public benefits upheld); *Startrans IO*, 130 FERC ¶ 61209 (2010) (acquisition premium pass-through denied because no tangible ratepayer benefits found); *In re Hawkeye State Telephone Co.*, 2 P.U.R. 4[th] 166 ("a mere change in ownership should not dictate a greater rate base and higher rates").

ratepayers because it could not "demonstrate cost reductions or other benefits exceeding the cost to customers of providing a return on the acquisition premium."[6]

Also, as I discussed in detail in my OVS, public utility regulators have rejected pass-throughs on grounds that utility customers should not have to pay twice for the inflated value of the same asset: once through allowed returns paid to the original owner (which include an inflation adder) and a second time by paying the purchasing entity's acquisition premium reflecting the inflated value of the asset. OVS at 14. As with the public benefits test, the double payment test applies in cases where there are no gamed purchase prices or other circularity concerns.

The bottom line is that FERC and other public utility regulators exclude premiums from utility rate bases due to basic notions of fairness to ratepayers. Ratepayers should not have to pay acquisition premiums if purchase prices are artificially inflated above original cost (circularity); if their service and benefits remain unchanged (no public benefits test); or if they are required to pay for the inflated value of the same asset twice (double payment test). And, it is simply wrong to say that the only fairness test is the circularity test. Many, indeed most, public utility acquisitions these days pass the circularity test, but premiums are rejected under the public benefits and double payment tests.

I also discussed in my OVS that public utility regulators, in applying the circularity test, do not require "total circularity" for the test to apply. OVS at 19. The key question is whether a firm acquiring another firm has monopoly pricing power over a portion of the acquired entity's

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[6] OVS at 16-17 (quoting Rebuttal Testimony of Brent E. Gale, Washington Utilities and Transportation Commission, Docket No. UE-051090, *In re: the Joint Application of MidAmerican Energy Holdings Co. and Pacificorp for an Order Authorizing Proposed Transaction* (dated Dec. 2005) p. 25).

customer base. Kolbe/Neels recognize that "there is a potential for a circularity problem even in industries that are only partially regulated" but claim that no such problems exist in this case because only a "*de minimis*" amount of traffic is subject to STB regulation. Reply JVS at 16.

Kolbe/Neels' conclusions concerning the regulatory scope of the STB are incorrect in my view. For example, a few years ago the Board found that revenue on all traffic "presumed eligible" for STB rate regulation was approximately $8 billion. *Simplified Standards for Rail Rates*, STB Ex Parte No. 646 (Sub-No. 1) (STB served July 28, 2006 at 29). I also understand that BNSF has presented workpapers in this case showing that in 2010 BNSF collected over { } in revenues on regulated traffic that also is "presumed eligible" for STB rate regulation. *See* Rebuttal VS Crowley/Fapp at 11-12. I do not believe that traffic at these revenue levels is "*de minimis*."

Also, from a regulatory fairness perspective, the number of impacted shippers should not be the deciding factor. The STB adjudicates rate cases, and sets maximum rates, based on complaints brought by individual shippers. The pertinent inquiry from a public policy perspective is not how many shippers are asked to pay premiums when there is no change in their service, but whether *any* individual shipper should see its regulated rates increase due to the application of an acquisition premium without offsetting benefits. In this respect, a critical element of the governing Rail Transportation Policy is "to maintain reasonable rates where there is an absence of effective competition" (49 U.S.C. § 10101(6)) and under the law, the Board is charged with ensuring that rates on traffic in dominated markets "must be reasonable." *Id.* at § 10701(d)(1).

III.

IT IS IMPROPER TO APPLY A NOMINAL RATE OF RETURN TO A REPLACEMENT COST INVESTMENT BASE

Kolbe/Neels suggest that the Board should adopt a "replacement cost" investment base for revenue adequacy purposes, and then apply a "nominal cost of capital" to that base for purposes of determining whether a rail carrier is revenue adequate. Reply JVS at 15-16. They further imply that inclusion of the Berkshire premium in BNSF's revenue adequacy net investment base is consistent with their suggestion. *Id.* at 20-23.

The Board recently rejected Kolbe/Neels' suggestion, and with good reason, in its decision in *Association of American Railroads – Petition Regarding Methodology for Determining Railroad Revenue Adequacy*, STB Ex Parte No. 679 (STB served Oct. 24, 2008). The Board found, among other things, that such an approach was "no[t] feasible," "would create the perverse incentive for railroads to maintain inefficient and obsolete facilities," and "would require an adjustment to the cost-of-capital estimate to exclude the inflation component." *Id.* at 5, 6, 7. I agree with the Board's assessment on all counts.

I also note that Kolbe/Neels are advocating a regulatory approach that Dr. Kolbe has expressly rejected elsewhere as one that "no regulatory system in the world" should utilize:

> The first thing to note is that no regulatory system in the world of which I'm aware attempts to set the rate base equal to the market value of the underlying assets. That would lead to the full exploitation of a utility's potential market power. I certainly don't recommend that, and I know of no economist who does. However,

> regulation in countries such as Australia, the United Kingdom, and New Zealand do base rates on a current-*cost* rather than a historical-cost rate base. (This was the basis of the FERC's "Trended Original Cost" rate base for oil pipelines.) Application of that system leads to a quite different pattern of utility capital charges over the life of an asset. Current costs increase with inflation, while historical costs do not. In order to avoid double-compensation for inflation, a Trended Original Cost ("TOC") rate base must use a lower rate of return, one with the "inflation premium" subtracted out. Economists refer to this as a "real" cost of capital, as opposed to the "nominal" cost of capital used with an Original Cost ("OC") rate base.

Rebuttal Testimony of A. Lawrence Kolbe, *West Virginia-American Water Co.*, Case No. 04-0373-W-42T (W. Va. PSC Aug. 16, 2004) pp. 30-31 (citations omitted) ("*West Virginia Case*").

Finally, Dr. Kolbe's testimony in the *West Virginia Case* confirms one of the points I made in my OVS: it is improper to apply a nominal cost of capital to a rate base that has been stepped up to current market value. This approach, as Dr. Kolbe recognized in the *West Virginia Case*, produces "double compensation for inflation." *Id.* The same "double compensation for inflation" will occur if the $8.1 billion acquisition premium is included in BNSF's net investment base, and returns are calculated for URCS and revenue adequacy purposes using a nominal cost of capital.

VERIFICATION

I, John W. Wilson, verify that I have read the foregoing Rebuttal Statement, know the contents thereof, and that the same are true as stated to the best of my knowledge, information and belief. Further, I certify that I am qualified and authorized to file this statement.

John W Wilson

John W. Wilson

Executed on December 16, 2011

Rebuttal Verified Statement of Robert E. Verrecchia

Finance Docket No. 35506
Western Coal Traffic League — Petition for Declaratory Order

December 20, 2011

Rebuttal Verified Statement of Robert E. Verrecchia

I am Dr. Robert E. Verrecchia. I presented an opening verified statement (OVS) in this proceeding on October 28, 2011. My curriculum vitae was included as Attachment No. 1 to my OVS.

I have been asked by counsel for the Western Coal Traffic League *et al.* to review and respond to the Verified Statement of Dr. Roman L. Weil (Weil VS) that was submitted to the Surface Transportation Board (STB or Board) by BNSF Railway Company (BNSF) on November 28, 2011.

Accounting Standards Cannot, and Do Not, Provide the Answers to the Ratemaking Policy Issues Raised in this Case

The principal issue in this case, as I understand it, is whether the Board should include an estimated \$8.1 billion dollar net acquisition premium that Berkshire Hathaway, Inc. (Berkshire) paid to acquire BNSF in 2010 in the Board's development of BNSF's Uniform Railroad Costing System (URCS) variable costs. I also understand that, because URCS variable costs are used for ratemaking purposes, inclusion of the premium in the BNSF URCS poses substantial adverse ratepayer impacts. Finally, I understand that with higher valued assets on BNSF's books, BNSF will appear to be less financially secure and further from "revenue adequacy" under the STB's annual revenue adequacy determination.

In my OVS, I explained that Generally Accepted Accounting Principles (GAAP) and standards adopted by the Financial Accounting Standards Board (FASB) were not intended to, nor do they, provide the answer to the question of whether the Board should or should not include the \$8.1 billion premium in BNSF's URCS and revenue adequacy net investment base:

> Regardless of how assets are recorded in financial statements under GAAP, GAAP does not require that regulators follow any accounting convention in establishing reasonable rates. GAAP and FASB do not govern or control ratemaking or other similar regulatory responsibilities. These responsibilities remain *exclusively* under the province of the regulator (here, the STB) and are not usurped by any GAAP financial reporting requirements. Regulators are not constrained under GAAP from making appropriate regulatory adjustments for regulatory ratemaking or revenue adequacy purposes.

OVS at 4.

Dr. Weil agrees with my conclusion. As he states on page 3 of his VS, "GAAP does not require the STB to use any accounting convention for its regulatory purposes." However, Dr. Weil contends that our shared agreement that GAAP and FASB standards do not govern STB ratemaking "misses the point." *Id.* According to Professor Weil, the question the Board must answer in this case is whether to incllude in BNSF's net investment base for URCS and revenue adequacy purposes either the value of the net investment base using what he refers to as "'predecessor cost' accounting" or "GAAP purchase accounting." *Id.* Dr. Weil claims that as a "policy matter" the Board should choose GAAP purchase accounting because it produces "economically accurate costs." *Id.*

Dr. Weil's conclusion is incorrect. Predecessor accounting and GAAP purchase accounting both produce "accurate costs" from an accounting standpoint, assuming each cost is correctly calculated. As applied here, and again assuming the costs were correctly accounted for, the net asset values recorded by BNSF prior to its acquisition by Berkshire reflect an "accurate" net cost that BNSF incurred to acquire the assets and the net asset values recorded by Berkshire after its acquisition of BNSF, which have been pushed down to BNSF, reflect an "accurate" net cost that Berkshire incurred to acquire BNSF. The two sets of "accurate" costs produce different net investment values because they are accurately measuring two different things: one is measuring predecessor costs, and the second is measuring acquisition costs. The policy issue the Board faces – whether to use acquisition costs or predecessor costs – is not one that can be answered by claiming one set of costs is more accurate than the other from an accounting standpoint, as both are equally accurate for their intended purpose, if correctly calculated.

Dr. Weil also argues that if the Board's policy goal is to value BNSF's net investment base for regulatory purposes at "fair value," by which he means the "fair values at the time of acquisition," then the Board should include the $8.1 billion acquisition premium in BNSF's net investment base. *Id.* at 4. However, Dr. Weil's reasoning is entirely circular, as his policy "assumption" dictates the accounting answer. One can just as easily assume that if the Board's policy goal is to protect captive rail shippers from having to pay higher rates simply because the ownership of BNSF changed hands, the Board should exclude the $8.1 billion premium from BNSF's net investment base.

The bottom line here is simple and clear: GAAP and FASB standards simply cannot – and do not – answer the policy question before the Board: whether to include or exclude the $8.1 billion dollar premium in the net investment base used for ratemaking purposes. As I stated in my OVS:

> Neither GAAP, nor the Financial Accounting Standards Board (FASB), which establishes the standards of financial accounting and reporting for nongovernmental entities, are designed to or are charged with addressing the ratemaking function of regulators.

Id. at 3.

GAAP is *not* primarily directed to regulation, and thus should *not* be relied on for ratemaking purposes. The accounting rules that underlie the acquisition method are designed to reconcile the purchasing entity's investment cost with the acquired company's net fair value, thereby ensuring that the purchasing entity's balance statement will continue to "balance" after a transaction has been consummated. The application of the GAAP acquisition method to a regulatory environment is fraught with many problems particularly because of its potentially unfair impact on regulated rate payers.

GAAP Generally Favors the Use of Historic Costs

GAAP is primarily, although not exclusively, based on the "historical cost principle." In other words, the value of an asset on the balance statement is based on the original, historical cost of the asset when the firm acquires the asset. This is especially true for those assets whose values dominate the balance statement, such as assets related to property, plant, and equipment (PP&E). For example, depreciation expense on PP&E, which can be described as the recovery of the original cost of the PP&E, is based on the *historical* cost of the PP&E – not some notion of the PP&E's "fair value" or "replacement cost." GAAP does not allow firms to restate PP&E to fair value or replacement cost, irrespective of compelling evidence in support of a restatement. For example, consider a firm that holds two otherwise identical parcels of land: assume that the firm paid $1 to acquire each parcel. If the firm sells one of the parcels for $10, nonetheless it must maintain on its balance statement the other parcel at $1. In other words, it cannot assign to the balance statement a fair value of $10 to the parcel that it does not sell despite compelling evidence in support of a restatement.

Alternatively, the acquisition of a firm by another firm, which requires the application of the acquisition method of accounting (*i.e.*, FAS 141R), is the rare and unusual circumstance in GAAP where the acquired firm's assets are restated to fair value. Thus, when Professor Weil opines that "GAAP purchase accounting is preferable as a policy matter to 'predecessor cost'," (*id.* at 3) where purchase accounting (actually, "the acquisition method" in the language of FAS 141R) requires that assets be re-assigned amounts based on their fair values, he fails to explain why – if fair values are preferable as a policy matter – they are not more widely applied. Once again, the acquisition of a firm by another firm is the rare and unusual circumstance where the acquired firm's assets are restated to fair value.

VERIFICATION

I, Robert E. Verrecchia, verify that I have read the foregoing Rebuttal Statement, know the contents thereof, and that the same are true as stated to the best of my knowledge, information and belief. Further, I certify that I am qualified and authorized to file this statement.

Robert E. Verrecchia

Robert E. Verrecchia

Executed on December 19, 2011

BEFORE THE
SURFACE TRANSPORTATION BOARD

Western Coal Traffic League Petition For Declaratory Order	)	**Finance Docket No. 35506**

Rebuttal
Verified Statement

Of
Thomas D. Crowley
President

and

Daniel L. Fapp
Vice President

L.E. Peabody & Associates, Inc.

On Behalf Of
Coal Shippers/NARUC

December 20, 2011

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LIST OF EXHIBITS

[1] Exhibit No. 1 through Exhibit No. 5 are included with our OVS.

I. INTRODUCTION

We are Thomas D. Crowley and Daniel L. Fapp. We are the same Thomas D. Crowley and Daniel L. Fapp that submitted an Opening Verified Statement ("OVS") in this proceeding on October 28, 2011. Copies of our credentials are included as Exhibit No. 1 and Exhibit No. 2 to our OVS, respectively. Our OVS addressed various aspects of Berkshire Hathaway Inc.'s ("Berkshire's") acquisition of the Burlington Northern Santa Fe Corporation and its primary subsidiary, the BNSF Railway Company (collectively "BNSF"). Specifically, our OVS:

1) Explained how Berkshire accounted for its acquisition of BNSF, including the allocation of the premium paid above BNSF's net book value;
2) Addressed how Berkshire's acquisition accounting impacts the financial and reporting statements included in BNSF's Annual Report Form R-1 submitted to the Surface Transportation Board ("STB");
3) Calculated the impact of the acquisition premium on the STB's BNSF Uniform Railroad Costing System ("URCS") variable costs; and
4) Discussed how acquisition accounting methods will impact BNSF shippers.

Because of these impacts, we concluded that the STB should exclude the purchase premium Berkshire paid for BNSF from the STB's regulatory determinations.

We have been requested by Counsel for the Western Coal Traffic League ("WCTL"), American Public Power Association, Edison Electric Institute, National Association of Regulatory Utility Commissioners, National Rural Electric Cooperative Association, Western Fuels Association, Inc., and Basin Electric Power Cooperative, Inc. ("Coal Shippers/NARUC") to address BNSF's Reply Evidence and Argument dated November 28, 2011. We have been asked to address the testimony of BNSF's witnesses Michael R. Baranowski and Benton V.

Fisher ("Baranowski/Fisher"), A. Lawrence Kolbe and Kevin Neels ("Kolbe/Neels") and John P. Lanigan as they relate to our OVS.

The remainder of our Rebuttal Verified Statement is organized below under the following topical headings:

II. Summary and Findings

III. Areas of Agreement With BNSF

IV. BNSF's Acquisition Impact On Shippers

V. Exclusion of the BNSF Acquisition Premium Is Proper

VI. Inclusion of the Premium is Inconsistent With SAC Cases

VII. Impact on Revenue Adequacy

II. SUMMARY AND FINDINGS

BNSF has not changed its operations because of the Berkshire acquisition and BNSF has indicated no changes are expected. The premium paid by Berkshire for BNSF provides no benefits for the railroad's shippers and should not be considered when calculating maximum reasonable rates based on the STB's standards. BNSF's Reply Evidence provides no information that contradicts or invalidates the findings in our OVS. In summary, we conclude:

1. Coal Shippers/NARUC and BNSF are in agreement regarding many issues related to the Berkshire acquisition and its impact on costs calculated by the STB. These areas of agreement include:

    a. BNSF has included its purchase adjustments and premiums in its Annual Report Form R-1 values;

    b. The acquisition premium equals $8.1 billion;

    c. The result of the accounting changes from Berkshire's purchase of BNSF is higher URCS variable costs; and

    d. The acquisition premium that is included in the STB URCS costs will not be offset by any future synergies related to the acquisition.

2. BNSF incorrectly asserts that the STB does not use cost of service regulatory practices. The STB uses cost of service estimates in many of its regulatory activities, including the determination of maximum reasonable rates.

3. BNSF is incorrect in its claims that only a small fraction of its customers will be impacted by increased URCS costs. In fact, a significant percentage of BNSF's regulated traffic is impacted and the aggregate carloads and revenues subject to changes in the STB's jurisdictional threshold is large.

4. Including the Berkshire acquisition premium in URCS will impact the calculation of maximum reasonable rates based on stand-alone costs ("SAC"). Baranowski/Fisher are wrong that the inclusion of the premium has no impact on the MMM calculation. In addition, in all cases the MMM ratios will be applied to issue traffic movements that will have higher variable costs due to the inclusion of the premium. The acquisition premium will also significantly adversely affect maximum reasonable rate calculations based on the simplified stand-alone cost ("SSAC") procedures and the three-benchmark ("3BM") procedures.

5. The inclusion of the purchase premium in BNSF's investment base will make the BNSF appear far less revenue adequate under STB revenue adequacy standards, which will directly impact 3BM cases in the short-run and could impact SAC cases in the long run. Additionally, the revenue adequacy impact will be felt even more in 2012 as the revenue adequacy calculations will rely wholly own acquisition-adjusted financial statistics.

III. AREAS OF AGREEMENT WITH BNSF

The BNSF's Reply acknowledged several areas where the BNSF agrees with the issues raised by Coal Shippers/NARUC. Both parties agree that the Berkshire acquisition will change the costs in BNSF's Annual Report Form R-1, and, therefore, the costs in BNSF's URCS formula. The question that remains is the general scope of the impact on captive BNSF customers. Each of the general areas of agreement between BNSF and Coal Shippers/NARUC is discussed below.

A. ADJUSTMENTS AND PREMIUMS IN THE R-1 VALUES

All parties in this proceeding are claiming that the BNSF's Annual Report Form R-1 includes the impact of Berkshire's acquisition of BNSF. In our OVS, we described and quantified for each affected Annual Report Form R-1 schedule the impact of the acquisition. BNSF's position is that the increased costs in its R-1 "would have little or no effect on the outcomes of a rate reasonableness cases…."[2] Baranowski/Fisher assert that the inclusion of the premium will be "more economically accurate" while the impact on costing will be "very small."[3] We disagree.

We agree with BNSF that its financial statements and schedules, including the allocation of the acquisition premium, were determined following Generally Accepted Accounting Principles ("GAAP"). The issue is not whether GAPP was followed but rather what costs the STB should use for regulatory costing. While the importance of the differences is discussed in our OVS and in the sections that follow in this Rebuttal Verified Statement, there is no challenge to the fact that the premium is included in the R-1 and what the value of the premium equals.

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[2] See BNSF Reply Argument, page 3.
[3] See Baranowski/Fisher Reply, page 4.

The "accuracy" of the numbers in the 2010 R-1 submitted to the STB is not an issue raised by Coal Shippers/NARUC in this proceeding. The costs before the acquisition premium were "accurate" and the costs after including the acquisition premium are also "accurate," assuming the costs associated with revaluing of the BNSF were done correctly. However, the two calculations are different measures of BNSF's costs. Pre-acquisition costs reflect economic value of assets devoted to public use while the valuation after the Berkshire acquisition reflects the new market value of those assets. The issue for the STB when developing variable costs for regulatory purposes cannot be resolved by an examination of which cost is most 'accurate" because both versions of the costs are "accurate." Instead, the STB must look at the purpose of the valuation and the impact on the shippers due to an artificial increase in costs.

B. VALUE OF THE ACQUISITION PREMIUM

Both Baranowski/Fisher and we calculated the value of the acquisition premium on BNSF's assets as equaling $8.1 billion.[4]

C. URCS COSTS ARE HIGHER WITH THE ACQUISITION PREMIUM

In our OVS, we explained why URCS costs increased due to the acquisition premium and showed examples of the impact of those costs on the movement of WFA/Basin's unit coal train traffic as well as hypothetical moves for coal and grain. Baranowski/Fisher also calculated the impact on URCS costs and concluded that "...the overall increase in BNSF's URCS variable costs attributable to the acquisition adjustment will fall somewhere between Crowley/Fapp's 4%

[4] Baranowski/Fisher's Table 1 shows a premium value of $8.139 billion. In our OVS, we showed the premium to equal $8.093 billion, a difference of $0.046 billion. The difference is due to differences in the change in deferred taxes. Based on the workpapers provided by BNSF, the acquisition was responsible for a change of { } in deferred taxes. Baranowski/Fisher utilized a value of { } which they did not source to any document.

and our 5.1% results."[5] There is no disagreement that costs will be increased; rather the issue is the magnitude of the increase and how that increase will impact shippers.

D. NO SYNERGIES WILL OFFSET THE ACQUISITION PREMIUM

In our OVS, we explained how in past merger and acquisition proceedings, the ICC/STB has relied on the potential for future synergies to justify the acquisition premium incurred by the merging railroads. In this proceeding, neither BNSF nor we have shown that any synergies will be achieved due to the Berkshire acquisition. Stated differently, there is agreement that the Berkshire acquisition will increase costs beginning in 2010 without any future potential cost savings.

[5] See Baranowski/Fisher Reply, page 3. These changes reflect estimated average changes for all BNSF movements. As we explain below, the change for specific movements may be above or below these average figures due to different factors including distance traveled and railcar ownership.

IV. BNSF'S ACQUISITION IMPACT ON SHIPPERS

BNSF has claimed that the Berkshire acquisition will have minimal impact on shippers because "BNSF's policy is to set its rates based on market conditions"[6] and "... only a small percentage of BNSF's traffic is even potentially subject to rate regulation by the Board."[7] BNSF's position is an oversimplification of the issue and a cavalier attempt to discount the impact on specific shippers by grouping all traffic together. As shown below, the impact of the acquisition premium impacts a sizable amount of traffic and has a direct impact on specific shippers. The impact of the acquisition premium on shippers is discussed under the following topics:

A. Rate Base in STB Ratemaking

B. Regulations Impact Railroad Values

C. Traffic Over the Jurisdictional Threshold

D. Impact on 3BM

A. RATE BASE IN STB RATEMAKING

In their Reply statement, Kolbe/Neels attempt to demonstrate the differences between ratemaking at the STB and other regulatory agencies, such as the Federal Energy Regulatory Commission ("FERC"). In their testimony, they state:

> ...it is true that in the context of original cost C-O-S [Cost of Service] regulation ("OC regulation"), acquisition premiums are typically excluded from a utility's rate base. However, the reasons that an acquisition premium would be excluded in markets where rates are regulated under OC regulation do not apply to industries like rail carriers, in which material competition constrains the rates the carriers can charge.

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[6] See Lanigan Reply, page 2.
[7] See Lanigan Reply, page 4.

> In the rail sector, there is no "rate base" for rate regulation purposes. All rail rates are set by the rail carriers themselves in the first instance based on market conditions and the demand they perceive for their service. Only a handful of rates are ever set by the STB and no rail rate is set based on OC regulation. In those limited circumstances where the STB does set rates, it applies a methodology based on market-based principles, in which regulated rates are intended to simulate competitive market outcomes.[8] (Emphasis added)

Kolbe/Neels' assertion that OC regulation does not factor into STB ratemaking and that there is no "rate base" in rail regulation is misplaced and inaccurate. The STB does rely on cost of service, i.e., variable costs, for the regulation of rates. The STB also relies on cost of service in the methodology applied to simulate the market rates for SAC. The reasons that costs are relevant are as follows:

1. The STB relies on variable costs to determine the jurisdictional threshold which is the prerequisite to bringing a maximum rate case to the STB;

2. As shown in several recent cases such as *KCPL,*[9] *OGE,*[10] and *AEPCO,*[11] the rate prescription relies on the jurisdictional threshold (180% of variable costs) so cost of service regulation is directly involved in setting rates. In other rate cases such as *WFA/Basin*,[12] the rate prescription relies on the application of the MMM R/VC ratio to the railroad's variable costs;

3. The MMM procedures to calculate SAC and SSAC R/VC ratios are directly impacted by variable costs;

4. Revenue adequacy calculations are directly impacted by the costs submitted by the railroads; and

5. The Three Benchmark procedures for small shippers rely on revenue/variable cost calculations.

The point here is that Kolbe/Neels have ignored the importance of developing accurate variable costs in determining maximum rates. URCS costs include a net investment base, and in

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[8] See Kolbe/Neels Reply, page 4.

[9] STB Docket No. 42095, *Kansas City Power & Light v. Union Pacific Railroad Company*, decided May 19, 2008 ("*KCPL*").

[10] STB Docket No. 42111, *Oklahoma Gas & Electric Power Company v. Union Pacific Railroad Company*, decided July 24, 2009 ("*OGE*").

[11] STB Docket No. NOR 42113, *Arizona Electric Power Cooperative, Inc. v. BNSF Railway Company and Union Pacific Railroad Company*, served November 22, 2011 ("*AEPCO 2011*")

[12] STB Docket No. 42088 (Sub No. 1), *Western Fuels Association, Inc. and Basin Electric Cooperative v. BNSF Railway Company*, served February 18, 2009 ("*WFA/Basin*").

calculating variable costs, return on investment at the current nominal cost of capital is included as part of the variable costs and resulting jurisdictional threshold calculation. BNSF's variable costs, including the acquisition premium, will have a direct impact on shippers.

B. REGULATIONS IMPACT RAILROAD VALUES

In our OVS, we demonstrated that the value of a railroad is dependent upon regulatory issues and that the railroads, along with the Association of American Railroads ("AAR"), supported this conclusion.[13] Mr. Lanigan believes that the "...parties completely misunderstand our statements" and "Our point is that expanded involuntary and uneconomic competitive access remedies and maximum rate regulation divorced from market principles *could* have a serious adverse effect on the railroads, *if* imposed by the STB."[14]

We have not misunderstood Mr. Lanigan's prior statements and Mr. Lanigan has downplayed the influence of regulation. BNSF is one of the most active litigants at the STB, and clearly understands the impact regulation has on its business profitability and value.[15] Even where no complaint or litigation is brought before the STB, the regulatory guidelines influence commercial negotiations between shippers and the BNSF. The STB has made this point itself in developing its regulatory procedures.[16] The impact of the acquisition premium on URCS costing will influence the decisions shippers make following the regulatory guidelines. BNSF has

[13] See pages 37 to 40 of our OVS. This issue was also discussed in Coal Shippers/NARUC's Reply at 17-18.
[14] See Lanigan Reply, page 7 (emphasis in original).
[15] See BNSF Railway Company SEC Form 10-K for the fiscal year ended December 31, 2010, page 6 "The STB has jurisdiction over disputes and complaints involving certain rates, routes and services, the sale or abandonment of rail lines, applications for line extensions and construction and consolidation or merger with, or acquisition of control of, rail common carriers. The outcome of STB proceedings can affect the profitability of BNSF Railway's business."
[16] See Ex Parte No. 657 (Sub-No. 1), *Major Issues In Rail Rate Cases*, served October 30, 2006 ("*Major Issues*"), page 12 "Third, use of either of these approaches [MMM or MCM] should facilitate rate case settlements and private negotiation," and Ex Parte No. 646 (Sub-No. 1), *Simplified Standards For Rail Rate Cases*, served September 5, 2007 ("*Simplified Standards*"), page 29 "Further, bright line demarcations [for rate case eligibility] provide regulatory certainty that should foster negotiation."

impact is substantial.[26] The increase in costs, solely due to the price paid by Berkshire for BNSF, removes this traffic from the ability to seek rate relief at the STB.

Regarding the magnitude of the traffic impacted, it is important to note that the ICC has previously recognized that small changes that may impact variable costs must be accounted for. When converting from Rail Form A to URCS as its General Purpose Costing System, the ICC noted that the jurisdictional threshold was set based on Rail Form A. In order to make the transition to URCS, the ICC developed a "bridge mechanism factor" of 0.9934 (i.e., 0.66%) to link Rail Form A to URCS.[27] This percentage is much less than the amount of traffic directly impacted by the BNSF's increase in costs.

D. IMPACT ON 3BM

The acquisition premium also impacts the small shipper cases that rely on the 3BM methodology. Baranowski/Fisher estimate that the effect of the acquisition premium on the Revenue Shortfall Allocation Methodology ("RSAM") to be 5 percent.[28] They go on to conclude that impact on the 3BM methodology would be "negligible."[29] We disagree.

The 3BM methodology relies on three R/VC ratios[30] to calculate the maximum rate.[31] The first benchmark is the RSAM which calculates the average revenue/variable cost ratio required for all potentially captive traffic, i.e., traffic moving with a revenue/variable cost ratio greater than 180 percent, required to make the railroad revenue adequate. Under the STB's procedures, the RSAM is averaged over the latest four years, i.e., when 2010 is added, the

[26] To place the number of carloads and revenues involved into perspective, Baranowski/Fisher indicated { } carloads with { } in revenue would be impacted. In our OVS, we estimated 122,669 carloads would be impacted by the purchase premium. Using Baranowski/Fisher's implicit average rate per car and applying this to our estimated car count means somewhere between { } and { } in revenue could be impacted. This amount of revenue is { }

[27] 5 I.C.C. 2d, 924.

[28] Baranowski/Fisher Reply, page 9.

[29] Baranowski/Fisher Reply, page 10.

[30] RSAM, Revenues to Variable Costs greater than 180% ("$R/VC_{>180}$") and the Comparable Group R/VC ratios.

[31] See, for example, the STB's decision in Docket No. EP 689 (Sub-No. 2), *Simplified Standards for Rail Rate Cases – 2009 RSAM and R/VC>180 Calculations*, served July 14, 2011.

RSAM will be the average of 2007 to 2010. The second benchmark, $R/VC_{>180}$, is the average revenue/variable cost ratio for all of the railroad's traffic that moves with a revenue/variable cost ratio greater than 180 percent. Like the RSAM ratios, the $R/VC_{>180}$ average is determined for the latest four years. The third benchmark is the average revenue/variable cost ratio for a comparison group of other potentially captive traffic involving the same or similar commodity and traffic characteristics ("R/VC_{COMP}"). The STB is currently evaluating whether the R/VC_{COMP} should be based on the latest year's traffic data as determined from the STB's Costed Waybill Sample or the latest four years STB Costed Waybill Sample data.

Baranowski/Fisher calculated the impact of the acquisition premium for the RSAM and $R/VC_{>180}$. Following the Baranowski/Fisher's methodology, for 2010, the RSAM equals { } percent based on the cost data filed by the BNSF. If the acquisition premium is removed, the RSAM ratio declines to { } percent, a decrease of { } percentage points.[32] When 2010 is added to the four year average, the four year average RSAM equals { } percent with the acquisition premium and { } percent without the premium,[33] an impact of { } percentage points or { } percent.

Continuing with Baranowski/Fisher's assumptions on the impact the purchase premium may have on its RSAM and $R/VC_{>180}$ ratios, a small shipper could lose over { } of its relief because of the purchase premium. This loss of { } of available relief is calculated by only adjusting the 2010 RSAM and $R/VC_{>180}$ ratios and the assumed variable costs to account for the purchase premium. Exhibit No. 6 contains the mathematical demonstration of this over { } loss in relief. These calculations using Baranowski/Fisher's assumptions demonstrate the

[32] See BNSF workpaper "BNSF Revenue Adequacy Summary 2004-2010-Reply.xlsx."

[33] For the ratio $R/VC_{>180}$, Baranowski/Fisher's calculation shows that the 2010 ratio {

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substantial impact that the acquisition premium will have on the 3BM cases when only 2010 data is introduced into the calculus.

We next expanded the impact of the RSAM and $R/VC_{>180}$ ratios to demonstrate the impact four years of premium would have on the ratios. As shown in Exhibit No. 7, the aggregate relief { } because of the inclusion of the premium over an estimate four year period.[34]

The use of the 2010 variable costs with the 4 year averages developed in the 3BM methodology also creates a disconnect in the costing. Assume that a shipper files a complaint that utilizes the STB's 2010 Costed Waybill Tape for the comparison traffic group. Those revenue/variable cost ratios are reduced due to the impact of the acquisition premium. However, the comparison is made to the 4-year average for RSAM and $R/VC_{>180}$, which is based on averages without the premium.

E. IMPACT ON COMMERCIAL NEGOTIATIONS

Mr. Lanigan suggests that "BNSF determines rates based on market conditions and demand for service."[35] However, in other instances, Mr. Lanigan has asserted that regulatory costs do impact the rates agreed to by BNSF.[36] We have participated in numerous commercial negotiations with BNSF, as well as the other railroads, and have seen firsthand where shippers have utilized the STB rate standards for negotiation purposes. In some cases, as acknowledged by Mr. Lanigan, the BNSF has agreed to reduced rates to avoid litigation. Increasing variable costs, as well as the jurisdictional threshold, due to the inclusion of the acquisition premium will

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[34] The amount of the lost relief is dependent upon the assumed future RSAM and R/VC>180 ratios, but our estimated impacts are consistent with historical averages plus the impact of the premium adjustments as calculated by Baranowski/Fisher.

[35] Lanigan Reply, page 3. Of course, in the sentence immediately preceding this statement, Mr. Lanigan states that "...BNSF does not *generally* determine rates based on the costs used for accounting purposes." (emphasis added)

[36] See Mr. Lanigan's statement in Ex Parte No. 657, *Rail Rate Challenges Under the Stand-Alone Cost Methodology*, April 20, 2005. Also see Coal Shippers/NARUC Reply at page 17-18.

push up rates that captive shippers will be able to negotiate. In our experience, BNSF now is attempting to set rates for shippers with competitive options at levels that are at, or above, the rates offered to captive shippers. Therefore, increasing the "rate floor" for captive shippers may also increase the rates offered to competitive shippers.

V. SYNERGIES IN PAST PROCEEDINGS

In our OVS, we showed how past merger/acquisition proceedings included synergies that would result in costs savings and other benefits to shippers and would effectively offset a premium paid by the acquiring railroad. BNSF does not dispute any of our conclusions, except regarding the Blackstone Group's ("Blackstone") acquisition of Chicago and North Western Transportation Company ("CNW"), which is addressed below. The ICC/STB approved past mergers because it believed the merger or acquisition would lead to rate reductions and other shipper benefits. Obviously, the ICC/STB relied on the calculation of costs and benefits as noted in the *Conrail* decision.[37]

In our OVS, we showed that when Blackstone acquired the CNW there were expectations of cost reductions and financial benefits that the ICC utilized to justify the acquisition premium in that proceeding. In BNSF's Reply Argument, BNSF attempts to criticize our description of the Blackstone acquisition by asserting that the ICC decision had "...no discussion of merger synergies..." and claiming that nothing suggested the synergies or financial benefit "...was the basis for the agency's use of acquisition cost to value the CNWT's assets."[38]

BNSF's criticisms are an issue of semantics. Whether or not the ICC called the cost savings or financial benefits "synergies" is irrelevant.[39] The savings were expected and part of the overall conclusion by the ICC that the acquisition was beneficial. BNSF does not deny that this occurred but rather attempts to say that this was not part of the ICC's rationale for approving the acquisition. In its decision in the Blackstone proceeding, one of the components of the ICC's order was that "Blackstone and CNWT must file...[quarterly]...a status report including the

[37] STB Docket No. 33388, CSX Corp. et al. – Control – Conrail, Inc. et al., 3 S.T.B. 196 ("*Conrail*").
[38] BNSF Reply Argument, page 9.
[39] As we explained in our OVS, cost savings are just one type of synergy, which can take many forms in mergers, including greater combined revenue potential, access to additional resources or more efficient combined operations. In other words, cost savings are synergies, but not all synergies are cost savings.

information on the implementation of the overhead cost reduction program, operating cost reduction program, asset sales and roadway property expenditures, as described in this decision."[40] It is incorrect for BNSF to now claim that the cost savings and other financial benefits were not the basis for ICC's approval in the Blackstone acquisition of CNW.

[40] 5 I.C.C. 2d, 1051.

VI. INCLUSION OF THE PREMIUM IS INCONSISTENT WITH SAC CASE

As discussed above, Berkshire accounted for its acquisition of BNSF using the Acquisition Accounting method, which resulted in a significant write-up in BNSF's assets due to Berkshire paying a premium above BNSF's book value for the railroad company. Baranowski/Fisher assert that our OVS demonstration that the Berkshire acquisition premium will impact rates under the SAC constraint is misguided, and that the book value of the defendant railroad's assets as well as URCS variable costs are totally irrelevant to the SAC test. [41] Additionally, while they acknowledge that inclusion of the premium in the BNSF URCS variable costs will adversely impact WFA/Basin, they assert that the impact is limited to this one case, and therefore, should be handled as a one-off exception. Finally, Baranowski/Fisher claim that since the STB's SSAC approach relies on the same key methodologies as the SAC methodology, the STB has no reason to make any adjustments for the purchase premium on those smaller cases. We believe all of Baranowski/Fisher's assertions regarding SAC and SSAC are incorrect as we explain below.

A. THE PURCHASE PREMIUM WILL IMPACT SAC RESULTS

Baranowski/Fisher claim that the inclusion of the purchase premium in the BNSF URCS variable costs will have no impact on the SAC portion of a rate reasonableness inquiry for two reasons. First, they state that the MMM approach that uses URCS variable costs is not really a part of the SAC test's basic inquiry, so therefore not a part of the SAC analysis. Second, they claim that even if it is part of the SAC analysis, any increase in the variable costs used in the MMM approach is off-set by a corresponding decline in MMM R/VC ratios.

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[41] See Baranowski/Fisher Reply, page 6.

1. **MMM Is A Part Of The SAC Analysis**

Baranowski/Fisher believe that because the application of the MMM is one of the last steps of testing rates under the SAC constraint that it is not part of the "basic inquiry" of a rate's reasonableness. Baranowski/Fisher's position is ridiculous. The timing of the application of the MMM to the SARR's overpayments has no bearing on its relevant importance to the rate reasonableness process, or the impact the acquisition premium will have on captive shipper rates. Under Baranowski/Fisher's logic, the validation of a SARR's operating plan in Rail Traffic Controller ("RTC") simulator is less relevant than the determination of a SARR's traffic since traffic identification is a key input into the RTC model. Both are critical elements in determining SAC, as is the MMM approach of allocating SAC. The fact that the STB addressed Maximum Rate Determination first in its *Major Issues* decision points toward the significance of the MMM in the SAC process.[42]

2. **MMM Results Are Impacted By Changes in Variable Costs**

More importantly, Baranowski/Fisher claim that the allocation of SAC under the MMM amongst the SARR shippers is not affected by changes in the defendant's variable costs because MMM allocates SAC based on each movement's relative R/VC ratio.[43] Baranowski/Fisher state that the size of the revenue requirement (e.g., SAC) allocated is not impacted based on a defendant's variable costs, and that an increase in the URCS variable costs for all shippers will preserve the same relative R/VC ratios, and thus the relative rates per ton will remain the same.[44] Baranowski/Fisher attempt to support their claim by including an example that shows a change

[42] See *Major Issues*, page 9.

[43] See Baranowski/Fisher Reply, pages 7 to 8.

[44] Baranowski/Fisher's claim that SAC is unaffected by changes in the defendant's URCS variable costs is also incorrect. Any part of the SAC procedures that uses URCS variable costs will be impacted by acquisition premium. This includes the determination of SARR revenues on cross-over traffic using the STB's average total cost ("ATC") division methodology. Changes in revenue divisions will directly impact the relief available under the SAC constraint by changing the over or under payments developed by in the Discounted Cash Flow models ("DCF") netting level and impact cross-over movement's R/VC ratios in the MMM model.

in URCS variable costs from the inclusion of the premium will have no impact on rate prescriptions.

Baranowski/Fisher's example and explanation are flawed, however, for several key reasons. Baranowski/Fisher assume that each movement's variable costs will increase by the same percentage when the purchase premium is included in the URCS variable costs. This assumption is incorrect. The inclusion of the purchase premium will impact movements differently depending on several factors, including the movement's distance and equipment ownership. For example, we have included in Table 1 below, the 2010 BNSF URCS variable costs including and excluding the purchase premium for three movements having identical movement parameters, except for distance.

Table 1
Comparison of Variable Costs With and Without Purchase Premiums

Movement Miles (1)	2010 Phase III Variable Costs Without Premium (2)	2010 Phase III Variable Costs With Premium (3)	Percent Change (4)
1. 100	$1.56	$1.68	7.8%
2. 500	$6.06	$6.38	5.3%
3. 1,000	$11.69	$12.26	4.8%

As shown above in Table 1, URCS variable costs for different movements do not change at uniform rates, but rather the shorter the movement, the greater the percentage increase in the variable costs.

Baranowski/Fisher acknowledge this fact in footnote 4 of their Reply VS, but assume it will have minimal impact. It is simple to see, though, that this change impacts the relative R/VC ratio for each of these movements, and therefore will change the relationships between the movements and ultimately the MMM answer. Assume for example that the rates for each of these movements equaled 200% of the BNSF URCS Phase III variable costs excluding the purchase premium (e.g., 200% times Column (2) from Table 1 above). After the inclusion of the acquisition premium, however, the relative R/VC relationship between these movements changes as shown in Table 2 below.

Table 2
Impact of Purchase Premium on R/VC Relationships

Movement Miles (1)	R/VC Without Premium (2)	R/VC With Premium (3)
1. 100	200%	186%
2. 500	200%	190%
3. 1,000	200%	191%

As the comparison of Columns (2) and (3) from Table 2 above shows, inclusion of the acquisition premium changes the relative R/VC ratios of the three movements, which will ultimately impact MMM rate prescription. It is clearly evident that the non-uniform change in variable costs for the different movements due to the inclusion of the acquisition premium will produce non-uniform changes in rates per ton contrary to Baranowski/Fisher's example.

The second flaw in Baranowski/Fisher's logic is that it does not take into consideration that the rates are set at the higher of the MMM R/VC or the 180% jurisdictional threshold. Baranowski/Fisher claim that the rate prescription per ton is unaffected by shifts in URCS variable costs because any variable costs increase is offset by a decline in the MMM R/VC ratio. Notwithstanding our demonstration above that variable costs do not change in a uniform way, Baranowski/Fisher's example does not take into considerations when the MMM model produces rates near the 180% jurisdictional threshold level. The STB is prohibited from prescribing rates below the 180% jurisdictional threshold meaning that when the MMM model produces R/VC ratios below 180%, the STB prescribes jurisdictional threshold rate levels. The inclusion of the purchase premium in URCS variable costs can drive the MMM R/VC below 180% and force a shipper to pay the jurisdictional threshold rate for no other reason than Berkshire paid a premium over book for BNSF.

A simple restatement of Baranowski/Fisher's Reply Table 1 demonstrates this issue. Table 3 below reconstructs Baranowski/Fisher's Reply Table 1 example, but adjusts the MMM R/VC ratios developed before the inclusion of the premium to a point slightly above the 180% jurisdictional threshold level.[45] Including the purchase premium in the URCS variable costs drops the MMM R/VC ratio as Baranowski/Fisher indicate, but in this instance it drops below the 180% jurisdictional threshold level. The net result is to force the shipper to pay a higher rate per ton when the 180% jurisdictional threshold is considered.

Table 3
Restatement of Baranowski/Fisher Table 1 To Include Jurisdictional Threshold Analysis

Description (1)	Source (2)	MMM w/o PAA (3)	MMM w/ PPA (VC increased 5%) (4)
SARR Assumptions:			
1. Revenue Requirement	Assumed	$100,000,000	$100,000,000
2. SARR Revenues	Assumed	$125,000,000	$125,000,000
3. Total VC	Assumed	$54,054,054	$56,756,757
4. MMM	L. 1/ L. 3	1.85	1.76
Movement Details:			
5. Tons	Assumed	50,000	50,000
6. Revenue	Assumed	$1,000,000	$1,000,000
7. Variable Costs	Assumed	$350,000	$367,500
8. R/VC Ratio	L. 6/ L. 7	2.857	2.721
Rate Prescription:			
9. MMM Revenue Allocation	L. 4 x L. 7	$647,500	$647,500
10. MMM Per Ton	L. 9 / L. 5	$12.95	$12.95
11. Jurisdiction Threshold Per ton	L.7/L.5 x 1.8	$12.60	$13.23
12. Prescription Per Ton	Higher of L.10 or 11	$12.95	$13.23

[45] Our use Baranowski/Fisher's example does not infer endorsement or acceptance of their conclusions, but rather simply shows another flaw in their logic.

As shown in Table 3 above, the MMM R/VC calculated using variable costs excluding the purchase premium equaled 185%. Using Baranowski/Fisher's assumption that variable costs would increase by 5% leads to the MMM R/VC falling to 176%, or four (4) percentage points below the 180% jurisdictional threshold level. Since the STB is restricted by statute from prescribing a rate below 180%, the shipper in this instance would have its rate set at $13.23 per ton rather than the $12.95 per ton if the premium had been excluded from the BNSF's URCS.

We have included other examples of the adverse impacts that the premium will have on the MMM model in our workpapers accompanying this verified statement.

B. THE INCLUSION OF THE PURCHASE PREMIUM WILL IMPACT SHIPPERS OTHER THAN WFA/BASIN

We demonstrated in our OVS that the inclusion of the purchase premium in the BNSF URCS will adversely impact WFA/Basin transportation costs by at least $25.1 million over the life of the STB's rate prescription.[46] Baranowski/Fisher acknowledge, as they must, that the increase in BNSF's URCS variable costs will lead to higher rates for WFA/Basin, but suggest that WFA/Basin is in a unique situation that should be addressed in a one time manner instead of making general changes to the BNSF's financial statements.[47]

Since the start of this proceeding, however, the STB has issued its decision in *AEPCO 2011*, which also used URCS variable costs excluding the purchase premium in its SAC analysis, but will have its rates set based on post-acquisition URCS variable costs. AEPCO finds itself in a similar situation to WFA/Basin where instead of the STB prescribing actual rates per ton as it

[46] The $25.1 million estimate is based just on the inclusion of the purchase premium in the URCS variable costs. If the exclusion of the BNSF from the STB's annual cost of capital determination is also accounted for, the financial impact increases to $31.5 million.

[47] See Baranowski/Fisher Reply, page 9.

had prior to *Major Issues,* it will have its rates based on a percentage of URCS variable costs, which have been driven higher by the impact of the Berkshire acquisition. We estimate the impact of the purchase premium on AEPCO to increase variable costs by $0.14 per ton for movements from the Lee Ranch, NM origin[48] and $0.32 per ton from the Eagle Butte, WY origin. Based on the STB's decision, which sets the maximum rate set at the jurisdictional threshold level, the impact on AEPCO's rates equals $0.25 per ton for Lee Ranch movements and $0.58 per ton for Eagle Butte movements.

The failure to exclude the acquisition premium will increase AEPCO's transportation costs over the remaining seven years (2012 through 2018) of the STB's prescription period by the amounts shown in Table 4 below.

[48] For AEPCO coal traffic originating at the Lee Ranch and El Segundo mines in New Mexico, the STB determined that a portion of the movement is handled by the Southwestern Railroad ("SWRR"), a short line railroad. Following STB's procedures, the SWRR variable costs for its portion of the movement are based on URCS Western Region unit costs. URCS Western Region unit costs are based on the average of all western Class I railroads, of which BNSF is the largest. We have not quantified the impact that the BNSF acquisition premium will have on URCS Western Region unit costs and by extension AEPCO rate levels. To that extent, our analysis understates the impact the BNSF acquisition premium will have on AEPCO's rates. Further, the inclusion of the BNSF acquisition premium will impact how the STB evaluates all western region short line railroads from a regulatory perspective because of the upward impact the BNSF acquisition premium will have on URCS Western Region unit costs.

Table 4
Increase In AEPCO's Expected Transportation Costs Associated With
The Inclusion of Berkshire's Acquisition Premium in BNSF's URCS Formulas

	Estimated Impact Of AEPCO's Transportation Charges From:	
Item (1)	**Lee Ranch** (2)	**Eagle Butte** (3)
1. AEPCO's Average 4Q11 Increased Rate Per Ton 1/	$0.25	$0.58
2. AEPCO's 4Q11 Increase In Transportation Charges 2/	$62,500	$145,000
3. AEPCO's Annual Increase In Transportation Charges Based On 4Q11 Experience 3/	$250,000	$580,000
4. AEPCO's Increase in Transportation Charges Over The Remaining Term Of STB's Prescription 4/	$1.8 million	$4.1 million

1/ Based on difference in jurisdictional threshold with and without acquisition premium.
2/ Line 1 x 250,000 tons.
3/ Line 2 x four quarter per year.
4/ Line 3 x seven remaining years beginning 2012. This analysis excludes the impact of the future variable cost increases during the remaining term of the STB rate prescription.

By not excluding the acquisition premium, Table 4 demonstrates that AEPCO's 4Q11 transportation charges will be increased between $0.25 per ton and $0.58 per ton depending upon the origin selected by AEPCO.[49] Annually, AEPCO's payments will be increased between $250,000 and $580,000 per year due to the inclusion of the acquisition premium in the BNSF costs (Table 4, Line 3). Over the remaining life of the STB's rate prescription period (Table 4, Line 4), AEPCO's transportation charges will increase between $1.8 and $4.1 million.

Baranowski/Fisher argue that the STB should address WFA/Basin's situation, and now presumably AEPCO's situation as well, as part of those individual cases and not as part of an adjustment to BNSF's financial statements and URCS variable costs. However, they did not address why the STB should take those steps beyond not deviating from GAAP. They do not

[49] These estimates are based on historic AEPCO shipping volumes. AEPCO also originates coal at the El Segundo mine near the Lee Ranch mine and can also take coal from the other BNSF origins near the Eagle Butte mine. If AEPCO increases the amount of coal it ships from these mines in the future, the aggregate increase will increase.

address why captive shippers should pay higher rates simply because Berkshire paid an amount above net book value for BNSF. Nor do they address the lack of synergies that existed in other merger/acquisition proceedings, but are absent from Berkshire's takeover of BNSF. Rather, Baranowski/Fisher infer that WFA/Basin, and by extension AEPCO, are the only shippers impacted, which, as we demonstrated above, is not the case. In fact, all future shippers who seek relief from the STB will be impacted.

C. SSAC IS ALSO IMPACTED BY THE BERKSHIRE ACQUISITION

Baranowski/Fisher also state that the inclusion of the purchase premium in the BNSF URCS variable costs will not impact cases adjudicated under the STB's SSAC approach for the same reasons they say the premium will not impact SAC cases.[50] They also infer the issue is irrelevant since the STB has never issued a rate prescription involving the BNSF using the SSAC methodology.

The issues with Baranowski/Fisher's positions that we discuss above relative to rates adjudicated under the SAC constraint are equally as applicable to rates brought to the STB under the SSAC process. As with a full SAC proceeding, SSAC uses the MMM approach and unadjusted URCS Phase III variable costs to set rates and the higher of the SAC or jurisdictional threshold levels. Additionally, the STB uses the ATC division methodology in SSAC as well to allocate revenues on cross-over traffic. The impact the purchase premium has on these approaches in SAC cases will have the same impact in SSAC cases.

Baranowski/Fisher attempt to rationalize these issues by indicating that BNSF has never had a rate prescribed using the SSAC approach. This point is irrelevant. As we have shown above, any future rate prescriptions brought under the SAC or SSAC approaches will be

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[50] See Baranowski/Fisher Reply, page 9.

impacted by the inclusion of the premium in BNSF's URCS variable costs. As such, the STB should remove the impact of the purchase premium no matter whether the case uses a SAC or SSAC approach.

VII. IMPACT ON REVENUE ADEQUACY

In our OVS, we demonstrated that the inclusion of the purchase premium in the BNSF's financial statements will push the BNSF further away from revenue adequacy under the STB's methodologies because of the increase in the railroad's net investment base. Baranowski/Fisher agree that this will occur, but indicate that it is of little relevance since the BNSF would have been declared revenue inadequate by the STB even if the acquisition had not taken place. We disagree with Baranowski/Fisher's conclusion. We also demonstrate that if the STB does not make an adjustment, the apparent showing of BNSF's revenue inadequacy will only increase in the future.

A. BNSF IS REVENUE ADEQUATE IN 2010 IF THE PROPER ADJUSTMENTS ARE MADE

The STB estimated in Ex Parte No. 552 (Sub-No. 15), *Railroad Revenue Adequacy – 2010 Determination*, served November 3, 2010, ("*2010 Revenue Adequacy*") that BNSF's return on investment ("ROI") including the impact of the purchase premium equaled 9.22 percent. In our OVS in this proceeding, we recalculated the STB's workpapers removing the impact of the acquisition, and estimated the BNSF's ROI excluding the purchase adjustments to equal 10.05 percent. Baranowski/Fisher also estimated the impact of the acquisition on BNSF's 2010 ROI in their Opening VS, but revised their estimate to 10.75 percent in their Reply VS indicating an error in their earlier calculation.[51]

We have reviewed Baranowski/Fisher's calculations of the restated the 2010 BNSF ROI excluding purchase adjustments and compared them to our own OVS calculations. While we used different approaches to our restatements, we produced very similar figures for restated year-

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[51] See Baranowski/Fisher Reply, pages 10 and 11.

end net investment base and accumulated deferred tax calculations.[52] We differ, though, on our calculation of combined/consolidated net railroad operating income ("NROI"). While we and Baranowski/Fisher included adjustments for changes in annual depreciation and tax effects in our NROI estimates, we did not include in our calculation the impact of reclassification of fuel hedges. These reclassifications required by GAAP flowed additional expenses through BNSF's income statements, and decreased the NROI compared to NROI excluding the purchase accounting adjustments. In this Rebuttal VS, we accept Baranowski/Fisher's estimate of the BNSF's NROI excluding the impact of the purchase accounting adjustments, and restate our 2010 ROI to 10.66 percent.[53]

In discussing the determination of BNSF's revenue adequacy including or excluding the purchase accounting adjustments, Baranowski/Fisher state that BNSF was revenue inadequate in 2010 since the STB's 2010 ROI calculation of 9.22 percent or their restated ROI of 10.75 percent was lower than the STB's 2010 railroad cost of capital 11.03 percent.[54] We disagree with Baranowski/Fisher's conclusion since they did not also adjust the 2010 cost of capital to reflect the exclusion of the BNSF from the cost of capital cohort after the railroad's acquisition by Berkshire. As we explained in our OVS, we estimated the railroad cost of capital assuming BNSF had remained in the cost of capital calculation would be 10.23 percent versus the 11.03 percent calculated by the STB. This is consistent with our showing in our OVS in the *2010 Cost of Capital* proceeding that demonstrated the exclusion of the BNSF from the cost of capital calculation lead on average to a higher industry cost of capital.[55]

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52 Baranowski/Fisher used a { } In contrast, we used a "bottom-up" approach that produced a year-end net investment of $33.4 billion and year-end net deferred taxes of $9.50 billion.

53 A copy of our restated ROI is included in our workpapers.

54 See Baranowski/Fisher Reply, page 11.

55 See Crowley/Fapp Opening VS in *2010 Cost of Capital*, pages 28 to 29.

If the STB is going to consider the impact on BNSF's ROI of the purchase accounting adjustments stemming from the Berkshire acquisition, it must also consider the impact of removing the BNSF from cost of capital calculation. Comparing this pre-acquisition cost of capital to BNSF's pre-acquisition ROI, and the ROI of other Class I railroads, we see that BNSF, UP, CSX and NS are revenue adequate for 2010.[56]

B. BNSF'S APPARENT REVENUE INADEQUACY WILL BE WORSE IN THE FUTURE

The STB concluded that BNSF's 2010 ROI equaled 9.22 percent. This ROI calculation only included the partial impact of the purchase accounting adjustments made by BNSF as part of its purchase. As shown in the STB's 2010 Revenue Adequacy calculations, the STB calculates adjusted investment in railroad property by calculating the simple average of the beginning and ending balance of each railroad's investment accounts. Averages are commonly used whenever a flow figure, or a figure that accounts for activity through the year, such as revenue or net income, is compared against a snapshot figure like net investment, which reflects a financial position at one point in time.

The beginning of the year BNSF figures used by the STB in its ROI calculation represented BNSF's pre-acquisition financial position, e.g., no purchase accounting adjustments. The year-end figures used represent post purchase accounting adjustments. Taking the average of the pre- and post-purchase adjustment investment figures mitigates some of the impact of the purchase adjustment on the ROI calculation. However, the real impact will come with the 2011 revenue adequacy determination when both the beginning and the end-of year investment figures

[56] See 2010 Revenue Adequacy at Appendix A showing CSXT ROI equaling 10.85 percent, NS ROI equaling 10.96 percent and UP ROI equaling 11.54 percent.

will reflect the purchase premium. This will decrease BNSF's apparent ROI and push it even further away from STB defined revenue adequacy.

An example of this impact can be readily determined by reviewing the STB's 2010 revenue adequacy determination.[57] If the BNSF's ending balance 2010 tax adjusted net investment base (which includes the premium) is substituted for the average 2010 tax adjusted net investment base (which includes the average with and without the premium), the 2010 BNSF return on investment falls from the 9.22% calculated by the STB to 8.05%,[58] a 13% reduction in BNSF's return on investment.

[57] Docket No. EP 552 (Sub-No. 15), *Railroad Revenue Adequacy – 2010 Determination*, decided November 2, 2011.

[58] BNSF 2010 net railway operating income of $2,675,869 ÷ BNSF 2010 tax adjusted net investment base-ending balance of $33,261,102 which equals 8.05%.

VERIFICATION

COMMONWEALTH OF VIRGINIA)
)
CITY OF ALEXANDRIA)

I, THOMAS D. CROWLEY, verify under penalty of perjury that I have read the foregoing Verified Statement of Thomas D. Crowley, that I know the contents thereof, and that the same are true and correct. Further, I certify that I am qualified and authorized to file this statement.

Thomas D. Crowley

Sworn to and subscribed
before me this 19th day of December, 2011

Diane R. Kavounis
Notary Public for the State of Virginia

My Commission Expires: November 30, 2012
Registration Number: 7160645

My Commission expires: November 30, 2012
Registration Number: 7160645

VERIFICATION

COMMONWEALTH OF VIRGINIA)
)
CITY OF ALEXANDRIA)

I, DANIEL L. FAPP, verify under penalty of perjury that I have read the foregoing Verified Statement of Daniel L. Fapp, that I know the contents thereof, and that the same are true and correct. Further, I certify that I am qualified and authorized to file this statement.

Daniel L. Fapp

Sworn to and subscribed
before me this day 19th day of December, 2011.

Diane R. Kavounis
Notary Public for the State of Virginia

My Commission expires: November 30, 2012
Registration Number: 7160645

EXHIBIT NO. 6
REDACTED

EXHIBIT NO. 7
REDACTED

CERTIFICATE OF SERVICE

I hereby certify that this 20th day of December, 2011, I have caused copies of the forgoing Joint Rebuttal Evidence and Argument to be served via first-class mail, postage prepaid upon all parties of record to this case.

Peter A. Pfohl